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## AICPA audit and accounting manual : nonauthoritative technical practice aids, as of June 1, 1999

Robert Durak

American Institute of Certified Public Accountants. Accounting and Auditing Publications

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### Recommended Citation

Durak, Robert and American Institute of Certified Public Accountants. Accounting and Auditing Publications, "AICPA audit and accounting manual : nonauthoritative technical practice aids, as of June 1, 1999" (1999). *Guides, Handbooks and Manuals*. 973.  
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AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# ***AICPA Audit and Accounting Manual***

***Nonauthoritative  
Practice Aids***

**As of June 1, 1999**

***AICPA Audit and Accounting Manual***  
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AICPA



**AICPA**

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# ***AICPA Audit and Accounting Manual***

## ***Nonauthoritative Practice Aids***

Edited by:  
Robert Durak, CPA  
*Technical Manager  
Accounting and Auditing Publications*

**As of June 1, 1999**



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ISBN 0-87051-277-3



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# HOW TO USE THIS VOLUME

## NEW CHANGES

This edition contains the following significant additions:

- A completely revamped State and Local Governments section (AAM section 12,000), reflecting all the latest changes and guidance concerning audits of state and local governments.
- Statement on Standards for Attestation Engagements (SSAE) No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3*, has been incorporated into all the affected report examples in AAM section 10,000.
- Report examples affected by guidance contained in Statement on Auditing Standards (SAS) No. 87, *Restricting the Use of an Auditor's Report*, have been updated.
- Improved guidance for auditing investments has been added to AAM section 5400.
- The sample representation letters for reviews of financial statements have been updated to reflect the Revised Illustrative Representation Letter for SSARS Review Engagements, just issued by the AICPA.

## 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*.

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# AAM Section 1000

## Introduction

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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.

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[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 <i>Accounting Standards Current Text</i>
APB =	AICPA Accounting Principles Board Opinion
AR =	Reference to section number in AICPA <i>Professional Standards</i> (vol. 2)
ARB =	AICPA Accounting Research Bulletin
AT =	Reference to section number in AICPA <i>Professional Standards</i> (vol. 1)
AU =	Reference to section number in AICPA <i>Professional Standards</i> (vol. 1)
EITF =	Emerging Issues Task Force consensus
FASBI =	FASB Interpretation
PB =	AcSEC Practice Bulletin
QC =	Reference to section number in AICPA <i>Professional Standards</i> (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



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George Dietz, Senior Manager—Accounting and Auditing Publications

Mary Schantz, Vice President—Professional Publications

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[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:

<u>Section No.</u>	<u>Section Name</u>
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.



- h. The Accountants' Reports section [AAM section 10,000] addresses the format of the accountants' report and numerous examples of the auditor's report.

## 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.

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*[The next page is 2001.]*

# 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.

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2600 Special Areas . . . . .	.01-.06
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Financial Statements Included in Certain Prescribed Forms . . . . .	.01
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<i>Section</i>	<i>Paragraph</i>
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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

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[The next page is 2101.]

# 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 ARSC has 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<sup>1</sup> or a comprehensive basis of accounting other than generally accepted accounting principles.<sup>2</sup> Financial forecasts, projections and similar presentations,<sup>3</sup> 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:<sup>4</sup>

- 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).

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#### 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.

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.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

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<sup>1</sup> 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.

<sup>2</sup> 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 . . .

<sup>3</sup> 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.

<sup>4</sup> 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.

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.

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[The next page is 2201.]

## AAM Section 2200

# *Engagement Planning and Administration*

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

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

.02 Rule 202 requires that an AICPA member who performs auditing, review, compilation, management consulting, 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, fraud, 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.

## Establishing an Understanding and Using 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.

.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. If an accountant is engaged to compile or review monthly financial statements, it is not necessary to obtain an engagement letter for each monthly report. An annual engagement letter, covering the services performed during that period, is sufficient.

#### ***The Content of the Understanding/Engagement Letter***

.10 An understanding and an 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 and limitations 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 report.
- A statement that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts; and that the accountant will inform the appropriate level of management of any material errors that come to his or her attention and any fraud or illegal acts that come to his or her attention, unless they are clearly inconsequential.
- A statement that if, for any reason, the accountant is unable to complete the engagement, he or she may decline to issue a report as a result of the engagement.
- 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.



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**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.

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***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.

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

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

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

vary from state to state, the accountant should also consult with legal counsel regarding the appropriate content of the letter.

## Change in Engagement Level of Service

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

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

- a. The reason given for the client's request, particularly the implications of a restriction on the scope of the audit (review).
- b. The additional audit effort required to complete the audit (review).
- c. The estimated additional cost to complete the audit (review).

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

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

- a. When the accountant has been engaged to audit an entity's financial statements and has been prohibited by the client from corresponding with the entity's legal counsel, the accountant is precluded from issuing a review or compilation report on the financial statements.
- b. For either an audit or review engagement, if the client refuses to provide the accountant with a signed representation letter, the accountant would be precluded from issuing a review report on the financial statements and would ordinarily be precluded from issuing a compilation report on the financial statements.

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

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

- a. the original engagement,
- b. any auditing or review procedures that may been performed, or
- c. scope limitations that resulted in the changed engagement.

.21 Interpretation 1 of SSARS 1, "Omission of Disclosures in Reviewed Financial Statements" (AR section 9100.01–.02), requires an accountant who undertakes to review financial statements and subsequently finds

that his client declines to include substantially all required disclosures, to include the disclosures in his review report. If the disclosures are not known, the report should specifically identify the nature of the omitted disclosures. However, SSARS 1, paragraph 19 [AR section 100.19], permits an accountant to compile financial statements that omit substantially all disclosures provided the omission is not undertaken with the intent to mislead.

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

## Predecessor and Successor Accountant

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

**.24** It also requires that a successor accountant who becomes aware of information that leads him or her to believe the financial statements reported on by the predecessor accountant may require revision to request that the client communicate this information to the predecessor accountant.

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

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

.27

<b>Client Acceptance and Continuance Form—Part I</b>
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:
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ADDRESS:

PHONE:	FISCAL YEAR END:
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FEDERAL I.D. NO.:	STATE I.D. NO.:
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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):


### 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: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Service	How Often?			Report Deadlines
	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:

--

**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

\_\_\_\_\_



## 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)?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 2. Are we aware of any significant disagreements between management (owners) and the predecessor accountant?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 3. Does there appear to be any potential fee collection problems?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 4. Are the client's needs beyond our capabilities or staffing abilities?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 5. Are we aware of any independence problems that may affect our ability to meet the client's needs?  | <input type="checkbox"/> | <input type="checkbox"/> |
| 6. Are there high-risk factors related to the engagement that may affect our decision to accept the client?   | <input type="checkbox"/> | <input type="checkbox"/> |
| 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)? | <input type="checkbox"/> | <input type="checkbox"/> |
| 8. Is the required staffing or expertise necessary for this engagement beyond our capabilities?   | <input type="checkbox"/> | <input type="checkbox"/> |

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**

BAILEY AND POTTER, P.S.

Certified Public Accountants

[Date]

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

Dear Mr. Gowers:

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 Gowers' Drug Stores for the year 19XX. We will not audit or review such financial statements. Our report on the annual financial statements of Gowers' Drug Stores is presently expected to read as follows:

We have compiled the accompanying balance sheet of Gowers' Drug Stores 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 statements will omit substantially all disclosures, will include 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 Gowers' Drug Stores for the fiscal year ended December 31, 19XX.

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

Our fees for these services will be billed as work progresses and are based on the amount of time required plus out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any

circumstances we encounter that could significantly affect our initial estimate of total fees, which will range from \$X,XXX to \$X,XXX.

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

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

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

Sincerely yours,

---

[Signature of Accountant]

Acknowledged:

Gowers' Drug Stores

---

[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**

VASHON, VASHON &amp; 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 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. Our review will consist primarily of inquiries of company personnel and analytical procedures applied to financial data and we will require a representation letter from management. 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 engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, we will inform that appropriate level of management of any material errors that come to our attention and any fraud or illegal acts that come to our attention, unless they are clearly inconsequential. We will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, we will not express such an opinion on them.

Our report on the financial statements is presently expected to read as follows:

We have reviewed the accompanying balance sheet of Island Security 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 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

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 &amp; HILL

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 Mr. John Henry as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. We will not audit or review such financial statements. Our report on the financial statements is presently expected to read as follows:

[Standard Compilation Report]

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

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

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

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

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

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

Sincerely yours,

\_\_\_\_\_  
[Signature of Accountant]

Acknowledged:

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

[Source: AICPA *Personal Financial Statements Guide*, appendix A.]

**.31 Illustrative Engagement Letter for Review of Personal Financial Statements**

LONGSTREET, JACKSON &amp; 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,

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*[Signature of Accountant]*

Acknowledged:

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*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, appendix A.]

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*[The next page is 2301.]*



# AAM Section 2300

## *Working Papers*

### Compilation Engagements

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

### Compilation Procedures

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

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

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

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

### Compilation Checklists

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

### Review Engagements

.05 As noted in AAM section 2100, a review of financial statements involves performing inquiry and analytical procedures. SSARS 1, paragraph 30 (AR section 100.30), discusses workpaper documentation for

review engagements. SSARS 1 (AR section 100) does not specify the form or content of the working papers in connection with a review engagement, but paragraph 30 does state that the working papers should describe the following:

- a. The matters covered in the accountant's inquiry and analytical procedures
- b. Unusual matters that the accountant considered during the performance of the review, including their disposition

### Review Procedures—Inquiry

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

- a. Inquiries concerning the entity's accounting principles and practices and the methods followed in applying them.
- b. Inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.
- c. Inquiries concerning actions taken at meetings of stockholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.
- d. Inquiries of persons having responsibility for financial and accounting matters concerning (1) whether the financial statements have been prepared in conformity with generally accepted accounting principles consistently applied, (2) changes in the entity's business activities or accounting principles and practices, (3) matters as to which questions have arisen in the course of applying the foregoing procedures, and (4) events subsequent to the date of the financial statements that would have a material effect on the financial statements.

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

### Review Procedures—Analytical

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

- 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

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

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

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

## Representation Letters

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

## Review Checklists

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

**.14 Short-Form Checklist for a Compilation Engagement**

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

Completed by \_\_\_\_\_ Date: \_\_\_\_\_

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

**.15 Review of Financial Statements—Illustrative Inquiries****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 Intercompany 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?

- (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)	$\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$		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	$\text{Accounts Payable} \times (\text{Days in a cycle}) / \text{Net Sales} \times (\text{Days in a year})$		compares A/P balance to net sales
Return on Total Assets	$\text{Net Income} \times (\text{Days in a year}) / \text{Total Assets} \times (\text{Days in a cycle})$		measures profitability at a point in time
Return on Net Worth	$\text{Net Income} \times (\text{Days in a year}) / \text{Net Worth} \times (\text{Days in a cycle})$		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



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	$\frac{\text{EBIT} \times (\text{Days in a year})}{\text{Net Worth} \times (\text{Days in a cycle})}$		ratio of earnings to net worth per year
Gross Profit Percentage	$\frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}}$		profitability calculation
Operating Expenses as a % of Net Sales	$\frac{\text{Operating Expenses}}{\text{Net Sales}}$		efficiency calculation
Times Interest Earned	$\frac{\text{EBIT}}{\text{Interest Expense}}$		profitability calculation
Income Before Tax to Assets	$\frac{\text{EBIT} \times (\text{Days in a year})}{\text{Assets} \times (\text{Days in a cycle})}$		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:

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

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

**.17 Illustrative Analytical Procedures Comparative Report**

**Sample Services, Inc.**  
**Analytical Procedures Comparative Report**  
**For the period ended December 31, 19XX**

Prepared by \_\_\_\_\_

Reviewed by \_\_\_\_\_

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

**.18 Review of Financial Statements—Illustrative Representation Letter**

[Prepared on Client's Letterhead]

[Date of Accountant's Report]

To [Accountant]

In connection with your review of the [identification of financial statements] of [name of client] as of [date] and for the [period of review] for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles (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 amounts 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. Also, there are no unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.\*
  - 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, except as disclosed in the financial statements.
  - h. There are no related party transactions including sales, purchases, loans, transfers, leasing arrangements, guarantees, and amounts receivable or payable to related parties 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. To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the financial statements.
  - k. We have no knowledge of concentrations existing at the date of the financial statements that make the entity vulnerable to the risk of a near-term severe impact that have not been properly disclosed in the financial statements. We understand that concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.

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\* If management has not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

- l. Management has identified all significant estimates used in the preparation of the financial statements.

The following additional representations may be appropriate in certain situations. This list of additional representations is not intended to be all-inclusive. In drafting a representation letter, the effects of other applicable pronouncements should be considered.

- m. The financial statements disclose all of the matters of which we are aware that are relevant to the entity's ability to continue as a going concern, including significant conditions and events, and our plans.
  - n. We have reviewed long-lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances have indicated that the carrying amount of those assets might not be recoverable and have appropriately recorded the adjustment.
  - o. Debt securities that have been classified as held-to-maturity have been so classified due to our intent to hold such securities to maturity and our ability to do so. All other debt securities have been classified as available-for-sale or trading.
  - p. We consider the decline in value of debt or equity securities classified as either available-for-sale or held-to-maturity to be temporary.
  - q. Receivables reported in the financial statements represent valid claims against debtors for sales or other charges arising on or before the balance-sheet date and have been appropriately reduced to their estimated net realizable value.
  - r. We believe that the carrying amounts of all material assets will be recoverable.
  - s. All agreements to repurchase assets previously sold have been properly disclosed.
  - t. We have made provisions for losses to be sustained in the fulfillment of, or from the inability to fulfill sales commitments.
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.

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[Name of Owner or Chief  
Executive  
Officer and Title]

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[Name of Chief Financial  
Officer and  
Title, where applicable]

[Source: SSARS 1, appendix D (AR section 100.55), as revised and published on the AICPA's Web site.]

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

**.19 Review of Personal Financial Statements<sup>1</sup>—Illustrative Representation Letter**

[Prepared on Client's Letterhead]

[Date of Accountant's Report]

[To the Accountant]

In connection with your review, of the statement of financial condition and the related statement of changes in net worth of James and Jane Person as of [date] and for the [period] then ended for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your review:

1. The financial statements referred to above present the financial condition and changes in net worth of James and Jane Person 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.) In that connection, we specifically confirm that—
  - a. The 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 year ended [date] in our accounting principles and practices.
  - c. We have no plans or intentions that may materially affect the carrying amounts 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 related party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties that have not been properly disclosed in the financial statements. 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.
  - f. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements have been properly recorded or disclosed in the financial statements.
  - g. Agreements to repurchase assets previously sold have been properly disclosed.
  - h. 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. Also, there are no unasserted claims or assessments that our lawyer has advised us are probable of assertion that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.<sup>\*</sup>

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<sup>1</sup> If a representation letter is to be used for a compilation engagement, as discussed in paragraph 1.22 of the AICPA *Personal Financial Statements Guide*, this illustrative representation letter should be modified as necessary to reflect the particular circumstances of the compilation engagement.

<sup>\*</sup> If the individual(s) have not consulted a lawyer regarding litigation, claims, and assessments, the representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

- i.* There are no material transactions that have not been properly reflected in the financial statements.
  - j.* We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged except as disclosed in the financial statements.
  - k.* We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
  - l.* To the best of our knowledge and belief, no events have occurred subsequent to the date of the statement of financial condition and through the date of this letter that would require adjustment to or disclosure in the financial statements.
  - m.* We have no knowledge of concentrations existing at the date of the financial statements that make the entity vulnerable to the risk of a near-term severe impact that have not been properly disclosed in the financial statements. We understand that concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.
  - n.* We have identified all significant estimates used in the preparation of financial statements.
2. We have responded fully to all inquiries made to us by you during the engagement.

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(James Person)

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(Jane Person)

**.20 Audit of Personal Financial Statements—Illustrative Representation Letter**

[Date]

[To the Independent Auditor]

We are providing this letter in connection with your audit of the statement of financial condition of James and Jane Person as of [date] and the related statement of changes in net worth for the [period] then ended for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial condition and changes in the net worth, of James and Jane Person in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the statement of financial condition and changes in net worth in conformity with generally accepted accounting principles.

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

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

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all financial records and related data.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. There has been no—
  - a. Fraud involving us, or others who have significant roles in internal control.
  - b. Fraud involving others that could have a material effect on the financial statements.
5. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
6. The following have been properly recorded or disclosed in the financial statements:
  - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
  - b. Guarantees, whether written or oral, under which we are contingently liable.
  - c. Significant estimates and material concentrations known to us that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]
7. There are no—
  - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.



- b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.<sup>1</sup>
  - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
- 8. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
  - 9. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

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

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(James Person)

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(Jane Person)

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<sup>1</sup> Footnote 7 of SAS No. 85, *Management Representations*, states that if a lawyer has not been consulted regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments. In the circumstances discussed in footnote 7 to SAS No. 85, this representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

**.21 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.

	<i>AR Ref.*</i>	<i>Initials</i>
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:	_____

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[The next page is 2401.]

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



# AAM Section 2400

## *Form and Content of Financial Statements*

### Statements Prepared

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

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

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

## 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.

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[The next page is 2501.]





# AAM Section 2500

## *Accountants' Reports*

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

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

- a. the accountant has compiled or reviewed the financial statements and his (her) report accompanies them,  
or
- b. the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that no responsibility is assumed for them.

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

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

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

- a. Generated, either manually or through the use of computer software, or
- b. Modified by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements. (See AR section 100.07.)

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

### Compilation Report

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

- a. A compilation has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
- b. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
- c. The financial statements have not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on them.

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

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

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

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

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

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

## Review Report

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

- a. A review has been performed in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
- b. All information included in the financial statements is the representation of management of the entity.
- c. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data.
- d. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements taken as a whole and, accordingly, no such opinion is expressed.
- e. The accountant is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles (GAAP), other than those modifications, if any, indicated in the report.

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

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

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

.15 If an accountant is unable to perform the necessary inquiry and analytical procedures to achieve the limited assurance which is contemplated by a review, or the client does not provide the accountant with a

representation letter, then the review is incomplete. Therefore, he or she would not have an adequate basis for issuing a review report. If this is the case, the accountant should consider whether in this situation the incomplete review also precludes the issuance of a compilation report on the financial statements. A change in the level of service is discussed in AAM section 2200.15 through .22.

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

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

## Modifications to Standard Report

### Omission of Substantially All Disclosures

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

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

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

### Omission of Statement of Cash Flows

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

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

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

### GAAP Departures

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

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

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

### Scope Limitations

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

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

### Going-Concern Uncertainties

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

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

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

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

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

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[The next page is 2515.]

## AAM Section 2510

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

### .01 Accountant's Standard Report

Addressee:

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

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

[Signature]

[Date]

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

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**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).]

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

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

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

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

**.03 Accountant Not Independent**

Addressee:

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

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

I am (We are) not independent with respect to XYZ Company.<sup>1</sup>

[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).]

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

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

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<sup>1</sup> 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).]

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



**.05 Departure from GAAP—Accounting Principles Not Generally Accepted**

Addressee:

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

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

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

[Signature]

[Date]

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

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**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).]

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

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

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

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

Addressee:

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

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

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

[Signature]

[Date]

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

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**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).]

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

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

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

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

Addressee:

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

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

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

[Signature]

[Date]

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

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**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).]

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

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

Addressee:

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

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

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

[Signature]

[Date]

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

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**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<sup>1</sup>**

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).]

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

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<sup>1</sup> A changed reference to a departure from generally accepted accounting principles includes the removal of a prior reference or the inclusion of a new reference.



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

Addressee:

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

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

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

[Signature]

[Date]

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

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**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).]

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

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

Addressee:

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

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

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

[Signature]

[Date]

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

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**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).]

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

**.17 Compilation Report—Financial Statements Accompanied by Supplementary Information**

Addressee:

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

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

[Signature]

[Date]

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

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**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).]

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

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

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

Addressee:

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

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

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

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

[Signature]

[Date]

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

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

Addressee:

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

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

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

*[Signature]*

*[Date]*

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



**.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) and SSARS 2, paragraph 19, (AR section 200.19).]

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[The next page is 2545.]



## 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).]

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**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).]

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

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

Addressee:

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

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

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

As disclosed in note X to the financial statements, the company has adopted (description of newly adopted method), whereas it previously used (description of previous method). Although the (description of newly adopted method) is in conformity with generally accepted accounting principles, the company does not appear to have reasonable justification for making a change as required by Opinion No. 20 of the Accounting Principles Board.

[Signature]

[Date]

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

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**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).]

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

**.05 Cash Basis Statements\*—Full Disclosure**

Addressee:

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

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

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

[Signature]

[Date]

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

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

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

**.06 Income Tax Basis Statements\*—Full Disclosure**

Addressee:

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

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

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

[Signature]

[Date]

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

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

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

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



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

Addressee:

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

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

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

[Signature]

[Date]

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

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**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).]

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

**.09 Continuing Accountant's Report on Comparative Statements—Both Periods Reviewed With Restatement of Prior-Period Financial Statements<sup>1</sup>**

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).]

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

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<sup>1</sup> 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).]

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

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

Addressee:

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

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

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

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

[Signature]

[Date]

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

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**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).]

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

**.13 Review Report—Supplementary Information Subjected to Review Procedures**

Addressee:

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

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

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

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

[Signature]

[Date]

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

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**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).]

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



**.15 Review Report—Emphasis of a Going Concern Uncertainty**

Addressee:

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

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

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

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

[Signature]

[Date]

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

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

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

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

Addressee:

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

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

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

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

[Signature]

[Date]

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

**.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) and SSARS 2, paragraph 18 (AR section 200.18).]

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[The next page is 2601.]



# 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).

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[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).]

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**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.)]

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



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

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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.<sup>1</sup>

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.

<sup>1</sup> An additional explanatory paragraph may be added after the second paragraph to emphasize matters relating to the attest engagement or the presentation of assertions.

# AAM Section 3000

## Engagement Planning and Administration

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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.

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# AAM Section 3100

## *Planning the Engagement*

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

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

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

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

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

.06 The steps in audit planning are as follows:

- a. Understand the scope of services and the nature of reports expected to be rendered.
- b. Decide whether or not to accept the engagement.
- c. Assign personnel to the engagement and prepare a preliminary time budget.
- d. Assess independence of firm and audit team.
- e. Understand the entity's business and the industry in which it operates.
- f. Assess the 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.]*



# 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\***

	<i>Nongovernmental Entities</i>	<i>State and Local Governments</i>
<i>Established Accounting Principles</i>	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
<i>Other Accounting Literature †</i>	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 <i>Technical Practice Aids</i> ; 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 <i>Technical Practice Aids</i> ; and accounting textbooks, handbooks, and articles

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[The next page is 3141.]

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

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

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

# AAM Section 3110

## *Assigning Personnel to the Engagement*

### General Comments

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

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm requirements for assigning personnel to engagements are addressed in the *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.

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*[The next page is 3161.]*

# AAM Section 3115

## *Independence*

### General Comments

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

.02 The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules, with emphasis on those related to financial interest, performance of accounting services for the client, and unpaid fees. Overall firm requirements for independence are addressed in AICPA's Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, paragraphs 7-10 (QC section 20.07-.10). (See AAM section 11,300.06-.07 for independence checklists for employees and other auditors.)

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

### Engagement Planning Procedures

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

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

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

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

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

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[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.<sup>1</sup>

### 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

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<sup>1</sup> 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.<sup>2</sup>

.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.<sup>3</sup>
- 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.

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#### 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.

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

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<sup>2</sup> 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.

<sup>3</sup> 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.

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



.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.

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*[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.

- 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.*

.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.

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### 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.

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.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:

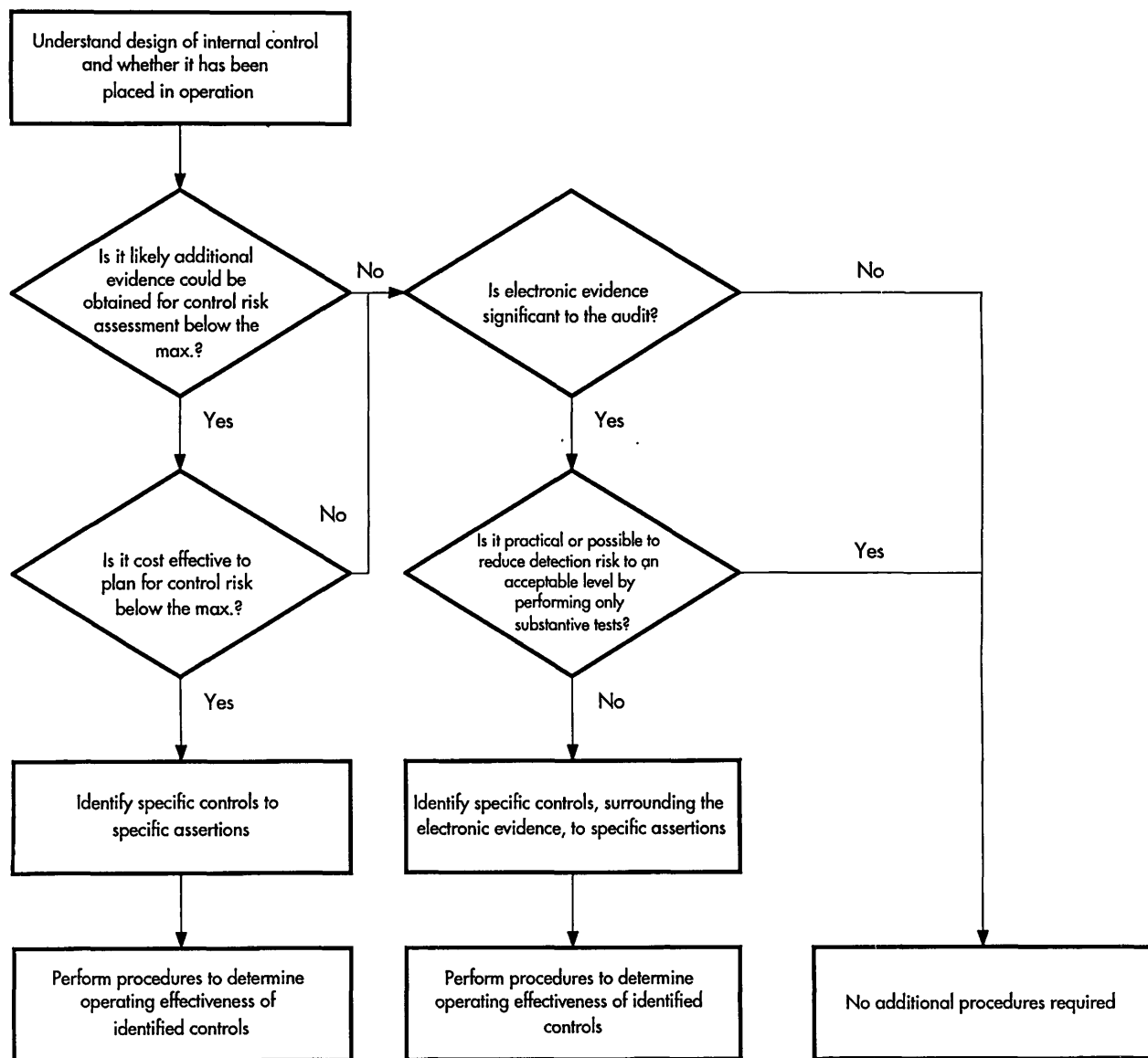


- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and
- Perform tests of controls to evaluate the effectiveness of such controls.

.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.



Lower Control Risk Assessment

Primarily Substantive Approach

[The next page is 3221.]

## AAM Section 3130

# *Establishing an Understanding With the Client and Preparing an Engagement Letter*

.01 Statement on Auditing Standards (SAS) No. 83, *Establishing an Understanding With the Client* (AU section 310), requires an auditor to gain an understanding with the client regarding the services to be performed for every engagement. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and limitations of the engagement. Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other party. The understanding could also include matters such as the timing of field work, report deadlines, and methods of fee determination and payment. The engagement partner should annually confirm an understanding of the nature of the engagement before beginning field work. Such understanding will normally include a pre-engagement client conference.

.02 SAS No. 83 requires the understanding with the client to be documented in the workpapers, preferably through a written communication with the client. 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 understanding with the client should be obtained and the letter should be prepared 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 understanding or a signed copy of the engagement letter should be filed with the engagement's current working papers and permanent file.

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### 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.

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.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 gaining an understanding with the client and while preparing an engagement letter:

- Whether the circumstances preclude an unqualified opinion, as in these examples:
  - The auditor is retained after the beginning of the client's fiscal year, did not observe inventories or confirm receivables at the beginning of the year and was unable to gain satisfaction through application of alternative procedures.
  - The client imposes restrictions on the scope of the audit. (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.
- 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
- The person or persons to whom reports should be addressed
- The number of copies needed of the report and the people to whom they are to be distributed
- Deadlines for reports or analyses
- Out-of-pocket costs
- Additional work not contemplated in the original engagement
- The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal controls)
- A retainer
- One-time engagements
- Start-up costs when the client changes accountants
- Underwriters' requirements in connection with public offerings
- The part of the work to be done by other accountants

## Contents of Engagement Letters

.08 An understanding with the client and an engagement letter regarding an audit of the financial statements generally includes the following matters:

- The objective of the audit is the expression of an opinion on the financial statements.
- Management is responsible for the entity's financial statements.
- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- Management is responsible for making all financial records and related information available to the auditor.
- At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.
- The auditor is responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.
- An audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, the auditor is responsible for ensuring that the audit committee or others with equivalent authority or responsibility are aware of any reportable conditions which come to his or her attention.

.09 The engagement letter should be addressed to the board of directors, chief executive, or to whomever retained the firm. The engagement partner should sign the letter on behalf of the firm. The client representative responsible for the engagement should sign the letter denoting agreement with the contract. The original letter should be maintained in the engagement workpapers. A copy of the letter should be given to the client.

.10 An understanding with the client and an engagement letter may include other matters, such as the following:

- Arrangements regarding the conduct of the engagement (for example, timing, client assistance regarding the preparation of schedules, and the availability of documents). A client-assistance schedule is often prepared as a separate attachment to the engagement letter.
- Arrangements concerning involvement of specialists or internal auditors.
- Arrangements involving a predecessor auditor.
- Arrangements regarding fees and billing. Estimates of fees should be based on conservative, carefully prepared estimates. The expected billing methods and payment periods should be described.
- Any limitation of or other arrangements regarding the liability of the auditor or the client, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management (regulators, including the Securities and Exchange Commission, may restrict or prohibit such liability limitation arrangements).
- Conditions under which access to the auditor's workpapers may be granted to others.
- Additional services to be provided relating to regulatory requirements.

- Arrangements regarding other services to be provided in connection with the engagement, such as income tax return preparation or consulting services.
- 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.)
- The extent and timing of interim auditing procedures.
- The name of the client's personnel to be contacted during the engagement.

.11 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.

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

- Reference in the letter to audit of the books and records rather than to audit of financial statements
- Adverse comments about other firms
- Failure to specify *in detail* the services to be rendered when a maximum fee is quoted
- Inclusion of a review of internal control as one of the services when what is really intended is a consideration of internal control as required by auditing standards
- Failure to identify accounting or other problems that may have an effect on the opinion
- Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because internal control was found deficient)
- Failure to include fee basis and payment terms
- Failure to identify subsidiaries
- Failure to identify specific tax returns to be prepared

## Investigatory Procedures for Individuals

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

.14 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 or she may within a reasonable time, by written request, be furnished disclosure of the nature and scope of the investigation.

## Sample Engagement Letters

.15 See AAM section 3175 for sample engagement letters.

.16 An Illustrative Planning Program, documenting procedures listed in this section, is located in AAM section 3165.

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[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."<sup>1</sup> 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.<sup>2</sup>

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.

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<sup>1</sup> 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.

<sup>2</sup> 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 is 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

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**

	<u>Initials</u>	<u>Date</u>
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,

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.

## 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.

## Special Concern—The Year 2000 Issue

### Background

.45 The Year 2000 (Y2K) Issue consists of two shortcomings of many electronic data processing systems that make them unable to process year-date data accurately beyond the year 1999 A.D. It is a broad business and operational problem, as well as an accounting systems problem.

.46 The first shortcoming is that, in the past, computer programmers have consistently abbreviated dates by eliminating the first two digits of the year under the assumption that these two digits would always be 19. Thus, January 1, 1965, became 01/01/65. Unless corrected, this shortcut is expected to create widespread problems when the clock strikes 12:00:01 A.M. on January 1, 2000. On that date, some computer programs may recognize the date as January 1, 1900, and process data inaccurately or stop processing altogether.

.47 The second shortcoming is that the algorithm used in some computers for calculating leap years is unable to detect that the year 2000 A.D. is a leap year. Therefore, systems that are not year 2000 compliant may not register the additional day, and date calculations may be incorrect.

.48 The Y2K Issue also may affect computer applications before January 1, 2000. Failures are expected to occur when systems attempt to perform calculations into the year 2000 (for example, some entities may not be able to process a credit card that expires in the year 2000 or beyond).

.49 In addition, some software programs use several dates in the year 1999 to mean something other than the date. Examples of such dates are 01/01/99, 09/09/99, and 12/31/99. As systems process information using these dates, they may produce erratic results or stop functioning.

.50 The Year 2000 Issue may affect software that is used to control operating equipment, operating systems, database and other information systems, and hardware that is dependent on microchips. The largest area of exposure for many entities is thought to be mainframes, because many of these use older software programs. For other entities, the largest area of exposure may be their operational activities (including production, service, and security activities).

.51 With planning and timely action by management, problems associated with the Y2K Issue may be mitigated or avoided.

.52 An entity should consider whether the Y2K Issue will adversely affect its suppliers' ability to manufacture or make timely deliveries of products or key components of the entity's products. It also should consider whether the Y2K Issue will adversely affect service providers that perform activities that have been outsourced to them. Additionally, if an entity's systems electronically communicate with other entities' systems (for example, through electronic data interchange or electronic funds transfers), the entity should consider the effect of the Year 2000 Issue on these communications.



.53 In summary, the Year 2000 Issue has the potential to affect any entity's accounting and information systems, the ability to manufacture its products or to deliver its services, and other aspects of its day-to-day operations on or before the year 2000. Entities must assess their year 2000 preparedness well in advance of January 1, 2000, and make year 2000 compliance a priority. If an entity has not yet begun to evaluate the possible effects of the Y2K Issue on its systems, new and old, it should begin the process immediately and implement corrective measures as soon as possible. The compliance efforts should include assessing the possible effects of the Y2K Issue on an entity's significant vendors and customers and taking any necessary actions.

## Implications for Auditors

.54 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Y2K Issue or by some other cause. The auditor also 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 following the date of the financial statements being audited. To assist auditors in applying current auditing standards in light of the Y2K issue, the Audit Issues Task Force (AITF) of the AICPA's Auditing Standards Board (ASB) has issued the following interpretations:

- Interpretation No. 4 of SAS No. 22, *Planning and Supervision*, "Audit Considerations for the Year 2000 Issue" (AU section 9311.38), provides guidance concerning:
  - The auditor's responsibility regarding the Y2K issue.
  - The impact of the Y2K issue on planning a financial statement audit conducted in accordance with generally accepted auditing standards.
  - The auditor's responsibilities when, during the course of an audit, he or she becomes aware of a Y2K issue that 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 in periods subsequent to the period under audit.
- Interpretation No. 2 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU section 9341.03), provides guidance to auditors regarding the identification and evaluation of conditions and events of the type identified in SAS No. 59 that relate to the Y2K issue. As with the Interpretation of SAS No. 22, this Interpretation incorporates the underlying concept that the auditor does not have to plan and perform procedures solely to identify the conditions and events relating to the Y2K issue. Rather, the auditing procedures performed in planning, gathering evidential matter, and completing the audit are sufficient for identifying conditions and events relating to the Y2K issue.
- Interpretation No. 3 of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls" (AU section 9324), provides guidance concerning:
  - The type of information about controls at a service organization related to the Y2K issue that would be considered relevant to user organizations and, therefore, should be included in a service organization's description of controls.
  - The service auditor's procedural and reporting responsibilities when relevant information about the Y2K issue is included in or omitted from the service organization's description of controls.
  - Clarification of the service auditor's responsibility, under SAS No. 70, to identify design deficiencies that do not affect processing during the period covered by the service auditor's examination, but may represent potential Y2K problems.

- Clarification about including in the service organization's description of controls information about the service organization's plans to modify its systems to address the Y2K issue.
- The service auditor's procedural and reporting responsibilities if a service organization includes information or a control objective in its description of controls that addresses its plans to modify its systems in response to the Y2K issue.
- Clarification about whether a service auditor's report may be expanded to describe the risk of projecting conclusions to future periods because of a failure to make needed systems changes in response to the Y2K issue.

.55 In addition, the AITF issued Interpretation No. 1 of SSAE No. 8, *Management's Discussion and Analysis*, "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis" (AT section 9700.01). This Interpretation discusses the practitioner's responsibilities with respect to the Y2K disclosures in an examination or review of MD&A performed in accordance with SSAE No. 8.

.56 For a complete explanation of the Y2K Issue and an explanation of an auditor's related responsibilities, see the publication entitled *The Year 2000 Issue—Current Accounting and Auditing Guidance*, which can be found on the AICPA's Web site. A questionnaire is included at AAM section 3165.13 to help auditors obtain an understanding of their client's Year 2000 compliance efforts. Additionally, practitioners should consult the most recent AICPA *General Audit Risk Alert* [AAM section 8010] for the latest update on the Year 2000 Issue.

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# 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

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- *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

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- *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.

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### 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.

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.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

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

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**Note:** A *Fraud Communication Checklist* is provided at the end of the "General Procedures" program in AAM section 5400.20 to help auditors comply with their responsibilities to report fraud to management, the audit committee, and others.

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.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. 84, *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 [AAM section 5400.20] to help auditors comply with their communication responsibilities concerning fraud.

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[The next page is 3301.]



# AAM Section 3150

## *Illegal Acts*

### General Comments

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

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

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*[The next page is 3331.]*

# AAM Section 3155

## *Analytical Procedures*

### General Comments

.01 Understanding financial relationships is essential in planning and evaluating the results of analytical procedures and generally requires knowledge of the client and the industry or industries in which the client operates. An understanding of the purposes of analytical procedures and the limitations of those procedures is also important. Accordingly, the identification of the relationships and types of data used, as well as conclusions reached when recorded amounts are compared to expectations, requires judgment by the auditor.

.02 Analytical procedures are used for the following purposes:

- a. To assist the auditor in planning the nature, timing, and extent of other auditing procedures.
- b. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.
- c. As an overall review of the financial information in the final review stage of the audit.

Analytical procedures should be applied to some extent for the purposes referred to in (a) and (c) above for all audits of financial statements made in accordance with generally accepted auditing standards. In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives.

.03 Analytical procedures involve comparisons of recorded amounts or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

- a. Financial information for comparable prior period(s) giving consideration to known changes.
- b. Anticipated results—for example, budgets or forecasts including extrapolations from interim or annual data.
- c. Relationships among elements of financial information within the period.
- d. Information regarding the industry in which the client operates—for example, gross margin information.
- e. Relationships of financial information with relevant nonfinancial information.

### Engagement Planning Procedures

.04 The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions. To accomplish this, the analytical procedures used in planning the audit should focus on (a) enhancing the auditor's understanding of the clients' business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things

as the existence of unusual transactions and events, and amounts, ratios and trends that might indicate matters that have financial statement and audit planning ramifications.

.05 Analytical procedures used in planning the audit generally use data aggregated at a high level. Furthermore, the sophistication, extent and timing of the procedures, which are based on the auditor's judgment, may vary widely depending on the size and complexity of the client. For some entities, the procedures may consist of reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance. In contrast, for other entities, the procedures might involve an extensive analysis of quarterly financial statements. In both cases, the analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

.06 Although analytical procedures used in planning the audit often use only financial data, sometimes relevant non-financial information is considered as well. For example, number of employees, square footage of selling space, volume of goods produced, and similar information may contribute to accomplishing the purpose of the procedures.

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

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[The next page is 3361.]

# AAM Section 3165

## *Illustrative Planning Program*

	<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
<b>.01 A. Understanding the Assignment</b>			
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.

	<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
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.	_____	_____	_____
<b>.02 B. Assigning Personnel to the Engagement</b>			
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.	_____	_____	_____
<b>.03 C. Independence</b>			
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.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
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, <i>Association With Financial Statements</i> , paragraphs 8–10 (AU section 504.08–.10).	_____	_____	_____
<b>.04 D. Knowledge of the Entity's Business</b>			
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.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
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. 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.			
7. Inquire of accounting, finance, operations, environmental, compliance, or legal personnel about their knowledge of the company's exposure to environmental remediation liabilities.	_____	_____	_____
8. 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.	_____	_____	_____

\* As applicable.



	<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
9. Consider methods the entity uses to process accounting information in planning the audit.	_____	_____	_____
10. 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.	_____	_____	_____
11. Consider whether specialized skills are needed to consider the effect of information technology on the audit.	_____	_____	_____
12. Document the matters listed above relating to a knowledge of the entity's business in the workpapers, as deemed necessary.	_____	_____	_____
<b>.05 E. Assessing Auditability</b>			
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.	_____	_____	_____

\* As applicable.

	<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
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.	_____	_____	_____
<b>.06 F. Understanding With the Client/Engagement Letter</b>			
1. Include the following items in the understanding obtained with the client or the engagement letter:			
a. Name of entity (and subsidiaries, if any) and its year end.	_____	_____	_____
b. Statement(s) to be audited.	_____	_____	_____
c. Scope of services, as detailed as necessary—including limitations of the engagement.	_____	_____	_____
d. Type of report(s) to be rendered.	_____	_____	_____
e. The objective of the audit.	_____	_____	_____
f. Management's responsibilities.	_____	_____	_____
g. A statement that management will provide a representation letter at the conclusion of the audit.	_____	_____	_____
h. The auditor's responsibilities, including the detection of misstatements, and the reporting of reportable conditions that come to the auditor's attention.	_____	_____	_____
i. A statement that the auditor may decline to issue a report if, for any reason, the auditor is unable to complete the audit.	_____	_____	_____
j. A statement that the audit is not designed to provide assurance on internal control or to identify reportable conditions.	_____	_____	_____
k. Provision for client's acceptance signature and date.	_____	_____	_____
l. Expression of thanks for being selected as auditors or to perform other services.	_____	_____	_____

\* As applicable.

	<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
2. Include the following optional items in the engagement letter, as deemed necessary:			
a. Obligations of the client's staff to prepare schedules and statements.	_____	_____	_____
b. Arrangements concerning the involvement of specialists or internal auditors.	_____	_____	_____
c. Arrangements involving a predecessor auditor.	_____	_____	_____
d. Fee or method of determining fee.	_____	_____	_____
e. Frequency of billing and client's obligations for payment, including retainer, if applicable.	_____	_____	_____
f. Any limitation of or other arrangements regarding the liability of the auditor or the client.	_____	_____	_____
g. Conditions under which access to the workpapers may be granted.	_____	_____	_____
h. Arrangements regarding other services to be provided.	_____	_____	_____
i. Description of a particular audit procedure, if requested by the client or deemed necessary for protection of the auditor.	_____	_____	_____
j. Extent and timing of interim auditing procedures.	_____	_____	_____
k. Name of client's personnel to be contacted during engagement.	_____	_____	_____
<b>.07 G. Assessing Audit Risk and Materiality</b>			
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.	_____	_____	_____

\* As applicable.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
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.	_____	_____	_____
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	_____	_____	_____

\* As applicable.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
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.	_____	_____	_____
<b>.08 H. Assessment of Control Risk</b>			
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.	_____	_____	_____
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.	_____	_____	_____
<b>.09 I. Illegal Acts</b>			
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.	_____	_____	_____

\* As applicable.

<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
-----------------------------------	-------------	----------------------

- |   |       |       |       |
|---|-------|-------|-------|
| 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.  | _____ | _____ | _____ |
| 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

### L. 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.

<i>Fraud Risk Factors Considered</i>		<i>Present at Client?</i>	<i>Audit Response Developed?</i> <sup>1</sup>	<i>Audit Response Documented? (W/P Ref.)</i> <sup>2</sup>	<i>Additional Information</i>
<b>A. Management Characteristics</b>					
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.					

<i>Fraud Risk Factors Considered</i>	<i>Present at Client?</i>	<i>Audit Response Developed?<sup>1</sup></i>	<i>Audit Response Documented? (W/P Ref.)<sup>2</sup></i>	<i>Additional Information</i>
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>B. Industry Conditions</b>				
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.				



<i>Fraud Risk Factors Considered</i>		<i>Present at Client?</i>	<i>Audit Response Developed?<sup>1</sup></i>	<i>Audit Response Documented? (W/P Ref.)<sup>2</sup></i>	<i>Additional Information</i>
<b>C. Operating Characteristics &amp; Financial Stability</b>					
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.					

<i>Fraud Risk Factors Considered</i>	<i>Present at Client?</i>	<i>Audit Response Developed?<sup>1</sup></i>	<i>Audit Response Documented? (W/P Ref.)<sup>2</sup></i>	<i>Additional Information</i>
<b>D. Susceptibility of Assets to Misappropriation</b>				
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.				
<b>E. Controls</b>				
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.				

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

<sup>2</sup> 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.

### .13 M. Year 2000 Questionnaire

To provide client service and to assist in client communications, auditors may wish to be aware of the steps their clients are taking to address the Year 2000 (Y2K) Issue. The following illustrative questions may help practitioners obtain an understanding of their client's Y2K compliance efforts and, at the same time, increase client awareness of the importance of the Y2K Issue. The list of questions is not meant to be comprehensive. Additionally, practitioners may want to tailor the questionnaire to the specific industry in which their clients operate.

These questions ordinarily would be addressed to the person or persons responsible for the Y2K compliance project within a client's organization, but they also may be useful in addressing the Issue with senior-level management.

Does the company have a year 2000 compliance project? Yes \_\_\_\_\_ No \_\_\_\_\_

If yes, please provide the following information about the project:

#### Project Planning and Program Management

Project Start Date \_\_\_\_\_

Where is the entity in the process?

- Planning Phase      • Assessment Phase
- Conversion Phase    • Implementation

Does the project address domestic and global compliance? Yes \_\_\_\_\_ No \_\_\_\_\_

Does the project address potential information technology (IT) exposure? Yes \_\_\_\_\_ No \_\_\_\_\_

Does the project address non-IT exposure (i.e., card key systems, elevators, etc.) Yes \_\_\_\_\_ No \_\_\_\_\_

Is the project on schedule? Yes \_\_\_\_\_ No \_\_\_\_\_

If no, explain the complications:

Does the project have executive sponsorship? Yes \_\_\_\_\_ No \_\_\_\_\_

Indicate the level: President \_\_\_\_ CFO \_\_\_\_ CIO \_\_\_\_ Controller \_\_\_\_

Does Year 2000 awareness exist throughout the organization (e.g., the IT department, user community, building services)? Yes \_\_\_\_\_ No \_\_\_\_\_

Is the Year 2000 budget separate from the information systems (IS) budget? Yes \_\_\_\_\_ No \_\_\_\_\_

Is the Year 2000 budget included within the IS budget? Yes \_\_\_\_\_ No \_\_\_\_\_

If included in the IS budget, does a process exist or will one be established to rank Year 2000 work according to priority within the context of the total budget? Yes \_\_\_\_\_ No \_\_\_\_\_

What is the estimated cost of compliance? \_\_\_\_\_

What is the anticipated project completion date? \_\_\_\_\_

Do you have a detailed project plan? Yes \_\_\_\_\_ No \_\_\_\_\_

Has a task force or group been created to address the issue? Yes \_\_\_\_\_ No \_\_\_\_\_

Is the task force considering enterprise-level issues as well as the impact on computer systems? Yes \_\_\_\_\_ No \_\_\_\_\_

How many people are included on the task force? \_\_\_\_\_

Does the task force include both internal and external resources?

Yes \_\_\_\_\_ No \_\_\_\_\_

Have accountabilities been clearly delineated between external and internal resources?

Yes \_\_\_\_\_ No \_\_\_\_\_

Are procedures in place to deal with "offshore" resources?

Yes \_\_\_\_\_ No \_\_\_\_\_

Have contingency plans been established to mitigate the risks associated with the project not being completed on time?

Yes \_\_\_\_\_ No \_\_\_\_\_

If yes, please describe:

Have a program management office and project plan been created?

Yes \_\_\_\_\_ No \_\_\_\_\_

Have the right resources and skill sets been identified and assigned?

Yes \_\_\_\_\_ No \_\_\_\_\_

Have critical milestones been established to indicate that current initiatives are on target?

Yes \_\_\_\_\_ No \_\_\_\_\_

### Approach

Has an application inventory been created?

Yes \_\_\_\_\_ No \_\_\_\_\_

Have tools been used to determine which code has been executed in the last year?

Yes \_\_\_\_\_ No \_\_\_\_\_

Has business risk for inventoried systems been defined?

Yes \_\_\_\_\_ No \_\_\_\_\_

Has a business risk rating been assigned to various suites of applications?

Yes \_\_\_\_\_ No \_\_\_\_\_

Have global implications been taken into account?

Yes \_\_\_\_\_ No \_\_\_\_\_

What is the compliance approach being taken by the client as to their computer systems?

- Replace many of the systems
- Modify them to be year 2000 compliant
- Depends on the system
- Undecided at this point

How is the problem being dealt with?

- Are year fields in data files being expanded?
- Is program code being modified to deal with the problem?

Yes \_\_\_\_\_ No \_\_\_\_\_

Yes \_\_\_\_\_ No \_\_\_\_\_

Has the client evaluated the need to convert historical data?

Yes \_\_\_\_\_ No \_\_\_\_\_

Does the client have any year 2000 assessment and conversion tools?

Yes \_\_\_\_\_ No \_\_\_\_\_

If so, please list:

### Testing Procedures

Are there documented enterprise-wide standards for testing?

Yes \_\_\_\_\_ No \_\_\_\_\_

What percentage of applications are under standards? \_\_\_\_\_

Do the users currently participate in test data preparation and execution?

Yes \_\_\_\_\_ No \_\_\_\_\_

Are the users aware they will be involved in test preparation and execution for the year 2000?

Yes \_\_\_\_\_ No \_\_\_\_\_

Are users aware they will be performing year 2000 testing along with their usual tasks?

Yes \_\_\_\_\_ No \_\_\_\_\_

**Application Status**

Indicate how many applications are at each stage of the year 2000 compliance process.

Compliant: \_\_\_\_\_

In process: \_\_\_\_\_

Planned: \_\_\_\_\_

No plans: \_\_\_\_\_

Do not need to  
be compliant: \_\_\_\_\_

Other: \_\_\_\_\_

Is there sufficient hardware available for the year 2000 project, especially for the testing?

Yes \_\_\_\_\_ No \_\_\_\_\_

Is another contingency being considered?

Yes \_\_\_\_\_ No \_\_\_\_\_

Have negotiations begun?

Yes \_\_\_\_\_ No \_\_\_\_\_

**External Vendors and Agents**

Are you working with any of the vendors listed below on year 2000 issues? Include any other types of vendors working on year 2000 issues for your organization.

- Hardware vendors
- Operational suppliers
- Application software vendors
- System software vendors
- Other vendors/financial services firms

Identify any of the external parties listed below with whom you are working on the Year 2000 Issue. Include any other types of external parties as well.

- Customers
- Counterparties
- Banks and other financial institutions
- Government and regulatory agencies
- Electronic data interchange (EDI)
- Other agents and clearing and executing facilities

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[The next page is 3381.]



# AAM Section 3170

## Audit Assignment Controls

.01

### Audit Time Budget — Sample A

Client \_\_\_\_\_ Audit date \_\_\_\_\_

Prepared by \_\_\_\_\_

Approved:

Supervisor \_\_\_\_\_ Date \_\_\_\_\_

Partner \_\_\_\_\_ Date \_\_\_\_\_

Preliminary work:

Start \_\_\_\_\_ End \_\_\_\_\_

Final work:

Start \_\_\_\_\_ End \_\_\_\_\_

	Budget (in hours)	
	May to Nov.	Dec. to April
Cash		
Receivables:		
Confirmation of balances		
Review ledgers, etc.		
Inventories:		
Observation of physical counts		
Price tests, etc.		
Securities and investments		
Property, plant, and equipment		
Accumulated depreciation and amortization		
Other assets		
Notes and accounts payable		
Tax accruals		
Other liabilities		
Capital stock		
Retained earnings		
Other equity accounts		
Income accounts		
Costs and expense accounts		
Current provision for taxes		
Other income and expense accounts		
Minutes, agreements, etc.		
Conferences with client		
General supervision and planning		
Review computer programs and auditability		
Review of internal control		
Review and update permanent files		
Travel		
Report and statement review		
Other matters		
Total budgeted hours		
(Excludes tax and report departments' time)		

**.02**

[illegible]



.03

Audit Time Analysis (Short Form)

	Client		Year Ended		Actual Daily Hours												Total	Next Year's Budget																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																																	
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**.04**

[illegible]



.05

Weekly Progress Report					
					Date _____
Supervisor _____		In-charge accountant _____			
Client _____		Case _____			
Staff days—seven hours					
	Original Estimate	Used to date	Unused	Est. to complete	Variance
In-charge accountant	_____	_____	_____	_____	_____
Assistants (list):	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____
Total assistants	_____	_____	_____	_____	_____
Grand total	=====	=====	=====	=====	=====

\_\_\_\_\_

[The next page is 3401.]

# AAM Section 3175

## *Sample Engagement Letters*

.01 Following are illustrative engagement letters (and one engagement memorandum). They may be used as guides in the design of specific letters, tailored to satisfy the terms of a particular engagement.

### .02 Audit Engagement Leading to Opinion

LACKO, LYNCH, BROWN & COMPANY

Certified Public Accountants

[Date]

Mr. Matt Decker, President  
Civil War Antiques, Inc.  
111 Burnside Highway  
Sharpsburg, Maryland 00000

Dear Mr. Decker:

This will confirm our understanding of the services we will provide to Civil War Antiques, Inc. for the year ending December 31, 19XX.

We will audit the balance sheet of Civil War Antiques, 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 establishment and maintenance of effective internal control over financial reporting, the establishment and maintenance of proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us.

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. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

We are responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that we obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.

An audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, we are responsible for ensuring that you are aware of any reportable conditions which come to our attention.

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.

As part of our engagement for the year ending December 31, 19XX, we will review the federal and state income tax returns for Civil War Antiques, Inc. Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

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

Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket 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.<sup>1</sup>

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]

---

<sup>1</sup> This paragraph is optional depending upon the nature of the engagement.

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

RON TRACY &amp; 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 establishment and maintenance of effective internal control over financial reporting, the establishment and maintenance of proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us.

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. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

We are responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that we obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.

An audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, we are responsible for ensuring that you are aware of any reportable conditions which come to our attention.

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. We will also audit the financial information included in the schedules required by Regulation S-X of the SEC. At the conclusion of our audit, we will request certain written representations from you about the financial statements and related matters.

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.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

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

Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket 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.<sup>1</sup>

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]

---

<sup>1</sup> This paragraph is optional depending upon the nature of the engagement.



**.04 Change in Circumstances From Those Contemplated in Original Engagement Letter**

RATZINGER &amp; 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 &amp; O'CONNOR, CPA'S

\_\_\_\_\_  
[Engagement Partner's Signature]

Accepted and agreed to:

\_\_\_\_\_  
[Client Representative's Signature]\_\_\_\_\_  
[Title]\_\_\_\_\_  
[Date]

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

GEROW, COLLINS & 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

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[Engagement Partner's Signature]

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**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**

SHERIDAN, CUSTER, AND STUART, CPAs

Certified Public Accountants

[Date]

Mr. John T. Chance, President

Skynet, Inc.

1 Wilderness Drive

Cold Harbor, Virginia 00000

Dear Mr. Chance:

This will confirm our understanding of the services we will provide in connection with the registration statement Skynet, Inc will file with the Securities and Exchange Commission.

We will audit the consolidated balance sheets of Skynet, Inc. as of December 31, 19X1 and 19X0, and the related consolidated statements of income, retained earnings, and cash flows for each of the years in the three-year period ended December 31, 19X1, which will be included in a Form S-1,<sup>1</sup> registration statement.

The financial statements are the responsibility of the Company's management. Encompassed in that responsibility is the establishment and maintenance of effective internal control over financial reporting the establishment and maintenance of proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us.

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. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

We are responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that we obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.

An audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, we are responsible for ensuring that you are aware of any reportable conditions which come to our attention.

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. We will also audit the financial information included in the schedules required by Regulation S-X of the SEC. 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*

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<sup>1</sup> This should be modified to agree with the particular form to be filed.

*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.

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 Skynet, Inc. Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket expenses. Invoices are payable upon presentation. 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 Sheridan, Custer, and Stuart, CPAs 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 Sheridan, Custer, and Stuart, CPAs 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.<sup>1</sup>

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,

SHERIDAN, CUSTER, AND STUART, CPAs

\_\_\_\_\_  
[Engagement Partner's Signature]

Accepted and agreed to:

\_\_\_\_\_  
[Client Representative's Signature]

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

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

<sup>1</sup> This paragraph is optional depending upon the nature of the engagement.

**.07 Sample Engagement Memorandum (When No Formal Engagement Letter Is Sent)****Engagement Memorandum**

The following understanding was agreed to between Gabreski and Bong, CPAs and Kramden Bowling, Inc.

[Date]	February 18, 19XX
Client	Kramden Bowling, Inc.
Address	1 Oak Street, Winchester, Virginia 00000
Phone	(555) 555-5555
Final arrangements made with	Ralph Marshall, President
Date final arrangements made	February 15, 19XX, at a meeting in the Kramden Bowling, Inc. offices
Client's personnel responsible for accounting matters	John Sandoval, Treasurer Bob Wesley, Controller
Objective of engagement	Audit engagement. Expression of an opinion on the financial statements. Also, review of federal and state income tax returns for year ended March 31, 19XX. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report.
Management's responsibilities	Management is responsible for the entity's financial statements, establishing and maintaining effective internal control over financial reporting, identifying and ensuring that the entity complies with the laws and regulations applicable to its activities, and for making all financial records and related information available to us. At the conclusion of the engagement, management will provide us with a letter that confirms certain representations made during the audit.
Auditor's responsibilities	We are responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that we obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform management of all matters of fraud that come to our attention. We will also inform the client of illegal acts that come to our attention, unless they are clearly inconsequential.

Internal control	An audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, we are responsible for ensuring that management is aware of any reportable conditions which come to our attention.
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
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)
Date audit to commence	Approximately April 24, 19XX (check with controller about April 10)
Estimated time required	Approximately three weeks
Staff requirements	Manager, supervisor, in-charge senior, and two staff assistants
Billing arrangements	Every two weeks, at standard plus out-of-pocket costs; invoices to attention of Bob Wesley; payable on presentation
Special accounting problems	Client was involved in a substantial sale and lease-back transaction during the year  Imputed interest may be required on long-term liabilities resulting from purchase of business
Other comments	Client is presently negotiating with machinists' union

**.08 Audit of Personal Financial Statements**

[Firm's Letterhead]

This will confirm our understanding of the terms and objectives of this engagement and the nature and limitations of the services I will provide.

I will perform the following services:

I will audit the statement of financial condition of \_\_\_\_\_ [client's name] as of December 31, 19XX, and the related statement of changes in net worth for the year 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 establishment and maintenance of proper accounting records, the selection of appropriate accounting principles, the safeguarding of assets, and compliance with relevant laws and regulations. You are also responsible for making all financial records and related information available to me.

My responsibility is to express an opinion on the financial statements based on my audit, and is limited to the period covered by my audit. If circumstances preclude me from issuing an unqualified opinion, I will discuss the reasons with you in advance. If, for any reason, I am unable to complete the audit or am unable to form or have not formed an opinion, I may decline to express an opinion or decline to issue a report as a result of the engagement.

I am responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that I obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. I will inform you of all matters of fraud that come to my attention. I will also inform you of illegal acts that come to my attention, unless they are clearly inconsequential.<sup>1</sup>

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 \_\_\_\_\_ [client's name], as well as evaluating the overall financial statement presentation. At the conclusion of the audit, I will request certain written representations from you about the financial statements and related matters.

As part of my engagement for the year ending December 31, 19XX, I also will prepare the federal and state income tax returns for \_\_\_\_\_ [client's name]. Further, I 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 you, 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 the audit.

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

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<sup>1</sup> 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.

My 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. My initial fee estimate assumes no unexpected circumstances will be encountered. I will notify you immediately of any circumstances I encounter that could significantly affect my 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 me. I appreciate the opportunity to serve you and trust that our association will be a long and pleasant one.

Sincerely,

---

*[Engagement Partner's Signature]*

Accepted and agreed to:

---

*[Client Representative's Signature]*

---

*[Title]*

---

*[Date]*

---

*[The next page is 4001.]*



# AAM Section 4000

## Internal Control

The material included in these sections on internal control is presented for illustrative purposes only. The comments and illustrations are neither all inclusive nor are they prescribed minimums. They are intended as conveniences for users of this manual who may want assistance when developing materials to meet their individual needs.

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

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# 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.

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# AAM Section 4200

## *Internal Control Framework*

### Introduction

.01 As described in AAM section 3125, Statement on Auditing Standards (SAS) No. 55 (AU section 319), as amended, provides a framework to help you obtain an understanding of internal control. That framework is built on two concepts: objectives and components.

.02 An *objective* is what the entity is trying to achieve. Generally, an entity tries to achieve objectives in the following three categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations

.03 For each of these objectives, internal control consists of the following five interrelated components:

- *Control environment*, which sets the tone of an organization and influences the control consciousness of its people. It is the foundation for all other components of internal control and provides discipline and structure.
- *Risk assessment*, which is the entity's identification and analysis of relevant risks to achievement of its objectives. It forms a basis for determining how the risks should be managed.
- *Control activities*, which are the policies and procedures that help ensure management directives are carried out.
- *Information and communication*, which are the identification, capture, and exchange of information in a form and time frame that enables people to carry out their responsibilities.
- *Monitoring*, which is a process that assesses the quality of internal control performance over time.

.04 Although an entity's internal control addresses objectives referred to in AAM section 4200.02, not all of these objectives and related controls are relevant to the audit of an entity's financial statements. Generally, controls that are relevant to an audit pertain to the entity's objective of preparing reliable financial statements for external purposes. An entity may have controls that relate to operations and compliance with laws and regulations that are not relevant to an audit and therefore need not be considered.

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

.06 *The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery, but ordinarily will not relate to the audit of the company's financial statement. If you*

*were the auditor of Jones Grocery, you may wish to ask about and document these controls for client service or other purposes, but since these controls are not relevant to the audit, you are not required to do so.*

.07 However, if controls relating to operations and compliance objectives pertain to data you evaluate or use in applying auditing procedures, then they may be relevant to the audit.

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

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

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

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

.11 The internal control framework described in SAS No. 55 (AU section 319), as amended, is only a means to help you consider the impact of an entity's internal control in an audit. Your primary concern is *not* the classification of a specific control into any particular component and related objective. Rather, your primary concern is whether a specific control affects financial statement assertions.

.12 *Suppose you are the auditor of Jones Grocery. As on all audits, you are required to obtain an understanding of internal control sufficient to plan the audit. To achieve this, you organize your inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objectives. As a result of performing your procedures, you discover the client's bank reconciliation procedures. Should a bank reconciliation be considered a "control procedure"? What about the fact that someone follows up and investigates old or unusual reconciling items? Is that considered a "monitoring" activity?*

.13 *These questions are rhetorical since the issue of how to classify a particular control is irrelevant for your purposes. As an auditor, your primary consideration is to understand how the bank reconciliations affect financial statement assertions relating to cash.*

.14 The purpose of this section is to provide guidance on each of the five components that comprise the internal control framework. This guidance should help you perform procedures to obtain an understanding of internal control. These procedures generally require the following steps:

- Understand internal control components that have a pervasive effect on the organization.
- Understand how computers are used to process significant accounting information.
- Understand control activities for significant account balances or transaction cycles.
- Assess the risk of management override and lack of segregation of duties.



## Focus on the Small Business Entity

.15 This section emphasizes the audit of a small business entity. Small business entities are typically characterized by—

- A single owner or a small group of owners who manage the business on a day-to-day basis.
- A small number of employees involved in the accounting function.
- No outside board of directors or internal audit function.
- The use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.16 This section provides some guidance for the audits of medium to large businesses. Additional guidance is provided in the Audit Guide *Consideration of Internal Control in a Financial Statement Audit*.

## Controls With a Pervasive Effect on the Organization

.17 Your client's control components consist of controls that either have a pervasive effect on the organization or are designed to address specific account balances and classes of transactions or activities. Initially, you should focus on the policies and procedures that have a pervasive effect on the organization.

## Understanding the Control Environment

.18 The control environment sets the tone of an organization. It influences the control consciousness of its people and is the foundation for all other components of internal control. In obtaining an understanding of your client's control environment, you should try to understand the owner-manager's attitude, awareness, and actions concerning the control environment. The following paragraphs describe some factors you should consider when evaluating your client's control environment.

.19 **Integrity and Ethical Values.** The effectiveness of internal control cannot rise above the integrity and ethical values of the owner-manager. Integrity and ethical values are essential elements of the control environment because they affect the design, administration, and monitoring of other internal control components.

.20 Management may *tell you* a great deal about their integrity and ethical values. They may even commit their *words* to a *written document*. Responses to inquiries and written policies are good, but as an auditor you should focus on management's *actions* and how these actions affect the entity on a day-to-day basis.

.21 In order for management's integrity and ethical values to have a positive impact on the entity, the following must exist.

- The business owner and management must personally have high ethical and behavioral standards.
- These standards must be communicated to company personnel. In a small business, this communication is often informal.
- The standards must be reinforced.

.22 When observing and evaluating management's *actions* be alert for the following:

- **Segregation of personal from business funds and activities.** Many small business owners intermingle their personal and business activities, for example, the company may pay the owner's credit card bills even if they contain non-business expenditures. You should consider the owner's attitude and the care with which he or she separates the personal from the business activities. It's not unusual for a business

to pay the owner's credit card bills, but the more important question is "does the owner reimburse the company?" Owners who treat company assets as if they were personal assets set a bad example for employees who may be encouraged to do the same.

- *Dealing with signs of problems.* Consider how management deals with signs that problems exist, particularly when the cost of identifying and solving the problem could be high. For example, suppose your client became aware of a possible environmental contamination on their premises. How would they react? Would they try to hide it, deny its existence, or act evasively if asked about it, or would they actively seek out your advice or the advice of their attorney?
- *Removal or reduction of incentives and temptations.* Individuals may engage in dishonest, illegal or unethical acts simply because the owner-manager gives them strong incentives or temptations to do so. Removing or reducing these incentives and temptations can go a long way toward diminishing undesirable behavior.

The emphasis on results, particularly in the short term, fosters an environment in which the price of failure becomes very high. *Incentives* for engaging in fraudulent or questionable financial reporting practices include—

- Pressure to meet unrealistic performance targets, particularly for short-term results.
- High performance-dependent rewards.
- Upper and lower cutoffs on bonus plans.

*Temptations* for employees to engage in improper practices include—

- Nonexistent or ineffective controls, such as poor segregation of duties in sensitive areas, that offer temptations to steal or conceal questionable financial reporting practices.
  - Owner-managers who are unaware of actions taken by employees.
  - Penalties for improper behavior that are insignificant or unpublicized and thus lose their value as deterrents.
- *Management intervention.* There are certain situations where it is appropriate for management to intervene and overrule prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the financial reporting information system. You should consider whether management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. Management intervention should be documented and explained.

**.23 Commitment to Competence.** Competence should reflect the knowledge and skills necessary to accomplish tasks that define an individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

**.24** *Mrs. Jones has always kept the books for Jones Grocery. She is "self-taught," with no formal training in accounting or bookkeeping. There are no plans to replace Mrs. Jones with someone more "qualified." As the auditor of Jones Grocery you recognized the risk of having an untrained bookkeeper and design your audit approach to address such concerns by—*

- *"Training" Mr. and Mrs. Jones to call you whenever they have a transaction out of the ordinary.*
- *Strongly encouraging Mrs. Jones to take training classes on her accounting software package. (She has.)*
- *Explaining to Mrs. Jones the importance of key accounting records such as the accounts payable subledger and inventory reports.*

- *Teaching Mrs. Jones important basic control functions such as bank reconciliations.*

**.25 Management's Philosophy and Operating Style.** Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include—

- The owner-manager's approach to taking and monitoring business risks.
- Attitudes and actions toward financial reporting and tax matters.
- Emphasis on meeting budget, profit, and other financial and operating goals.

**.26** Management's philosophy and operating style have a significant influence on the control environment, particularly in a small business where the owner-manager dominates the organization, regardless of the consideration given to the other control environment factors. For example, you may be concerned about your client's unduly aggressive attitude toward financial reporting. Not only might this cause you to assess control risk at the maximum for some or all assertions, but it may heighten concerns about irregularities affecting certain assertions.

**.27** However, a dominant owner-manager does not necessarily cause you to assess control risk at the maximum.

**.28** *Mr. Jones dominates the management of Jones Grocery. He demonstrates a positive attitude toward the control environment and a moderate to conservative attitude toward accepting business risk such as expansion. He is more concerned about taxes than financial reporting. Mr. Jones uses information generated by the financial reporting information system to monitor the financial results of the company and compare it to prior periods. His review of the accounting reports encourages Mrs. Jones and others who help with the accounting to work with greater care. Mr. Jones also performs many control activities himself, such as the review and supervision of the physical inventory counts. Although Mr. Jones is concerned about his income tax liability, you might not view the possible bias to misstate income as a significant risk because of the otherwise positive control environment.*

**.29 Organizational Structure.** Your client's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and monitored.

**.30** Significant aspects of establishing an organizational structure include considering key areas of authority and responsibility and appropriate lines of reporting. Small business entities usually have fairly simple organizational structures. A highly structured organization with formal reporting lines and responsibilities may be appropriate for large entities, but for a small business, this type of structure may impede the necessary flow of information.

**.31 Assignment of Authority and Responsibility.** The assignment of authority and responsibility includes the following:

- The establishment of reporting relationships and authorization procedures
- The degree to which individuals and groups are encouraged to use initiative in addressing issues and solving problems
- The establishment of limits of authority
- Policies describing appropriate business practices
- Resources provided for carrying out duties

**.32** Alignment of authority and accountability often is designed to encourage individual initiatives, within limits. Delegation of authority means surrendering central control of certain business decisions to lower echelons, to the people who are closest to everyday business transactions.

.33 A critical challenge is to delegate only to the extent required to achieve objectives. This requires ensuring that risk acceptance is based on sound practices for identifying and minimizing risk, including sizing risks and weighing potential losses versus gains in arriving at good business decisions.

.34 Another challenge is ensuring that all personnel understand the entity's objectives. It is essential that each individual knows how his or her actions interrelate and contribute to achievement of the objectives.

.35 *Mr. Jones had to decide how to delegate authority and responsibility when he expanded Jones Grocery from the one, original store to its present eight-store chain spread out over Greater Anytown and the surrounding suburbs. One area that proved problematic was setting prices. Mr. Jones assumed that he would be able to set the prices at all the stores, just like he did for his original store. He felt this was a good procedure because it allowed him some control over profit margins. Problems arose because the competitive pressures were different in different areas of the city. A competitor in the North Suburb ran specials or lowered prices on certain items, while a competitor in the Western Suburb ran specials on different items. It became too difficult for Mr. Jones to keep up with the constantly changing price battles at eight different stores. He eventually delegated this responsibility to the individual store managers. He set a limit on how much a store manager could discount prices without his prior approval, but other than that, the store managers had the freedom to set prices to respond to the changing competitive environment.*

.36 *The responsibility for accounting information was also affected by Jones Grocery's expansion. Mr. Jones' original thought was that each store would be run as a separate business, with separate financial reporting information systems that would be "consolidated" together at the main store. Problems soon developed in several areas, most notably accounts payable. The store managers were responsible for entering vendor invoices into the computer system. But it seemed that no matter how much Mr. Jones threatened, cajoled, and begged his store managers to enter the invoices on a timely basis, they just couldn't do it consistently. The procedure had to be changed. Now, the store managers only have the responsibility to check incoming goods for quantity and condition. Vendor invoices are sent directly to Mrs. Jones at the main store, and she is responsible for maintaining the accounts payable for all the stores.*

.37 The control environment is greatly influenced by the extent to which individuals recognize that they will be held accountable. This holds true all the way to the owner-manager, who has the ultimate responsibility for all activities within the organization, including internal control.

.38 **Human Resource Policies and Practices.** Human resource policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Human resource policies and practices include an entity's policies and procedures for hiring, orienting, training, evaluating, counseling, promoting, compensating, and taking remedial action. In many small businesses, the policies may not be formalized but they should nevertheless exist and be communicated. The owner-manager can orally make explicit his or her expectations about the type of person to be hired to fill a particular job, and may even be active in the hiring process. Formal documentation is not always necessary for a policy to be in place and operating effectively.

.39 *When Mr. and Mrs. Jones added a second store, the hiring of a store manager was easy—they hired their daughter. Adding a third store proved to be more problematic, since the other Jones children had no interest in the family business. Mr. and Mrs. Jones talked at length about the type of person they would hire as a store manager. They finally decided it was more important to hire someone they could trust, someone they felt comfortable with on a personal level rather than someone with an extensive background in the grocery business. They felt they could teach someone the grocery business but not how to be trustworthy. That hiring policy worked, and they've been following it ever since.*

.40 Standards for hiring the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior, demonstrate an entity's commitment to competent and trustworthy people. Hiring practices that include formal, in-depth employment interviews and informative and insightful presentations on the company's history, culture, and operating style send a message that the company is committed to its people.

.41 Personnel policies that communicate prospective roles and responsibilities and that provide training opportunities indicate expected levels of performance and behavior. Rotation of personnel and promotions driven by periodic performance appraisals demonstrate the entity's commitment to advancement of qualified personnel to higher levels of responsibility. Competitive compensation programs that include bonus incentives serve to motivate and reinforce outstanding performance. Disciplinary actions send a message that violations of expected behavior will not be tolerated.

## Other Control Components With a Pervasive Effect on the Organization

.42 Elements of other control components may have a pervasive effect on the organization. These are discussed in the following paragraphs.

.43 **Risk Assessment.** An entity should identify, analyze, and manage risks relevant to the preparation of reliable financial statements. For example, risk assessment may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

.44 Risks relevant to financial reporting include events and circumstances that may adversely affect the company's ability to record, process, summarize, and report financial data. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

.45 Risks can arise or change due to circumstances such as the following:

- *Changes in the operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel.* New personnel may have a different focus on or understanding of internal control. When people change jobs or leave the company, management should consider the control activities they performed and who will perform them going forward. Steps should be taken to ensure new personnel understand their tasks.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control. When these systems are changed, management should assess how the changes will impact control activities. Are the existing activities appropriate or even possible with the new systems? Personnel should be adequately trained when information systems are changed or replaced.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls. Management should consider whether accounting and information systems are adequate to handle increases in volume.
- *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New lines, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

.46 Your procedures to assess whether a risk assessment process is placed in operation are generally of an inquiry nature. For example, you may ask accounting personnel what accounts they believe are the most difficult to become satisfied with as they prepare the financial statements. You may also consider asking the same questions of personnel outside the accounting department.

**.47 Control Activities.** Control activities are policies and procedures that help ensure necessary actions are taken to address risks to achieve the entity's objectives. Control activities have various objectives and are applied at various organizational and functional levels.

**.48** At the entity-wide level, control activities may be categorized as policies and procedures that pertain to the following.

- *Performance reviews.* These control activities include reviews of actual performance versus budgets, forecasts, and prior-period performance. They may also involve relating different sets of data (for example, operating or financial) to one another, together with analyses of the relationships, investigating unusual relationships and taking corrective action. Performance reviews may also include a review of functional or activity performance.
- *Information processing.* A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are general controls and application controls. General controls commonly include controls over data center operations, system software acquisition and maintenance, and access security. Application controls apply to the processing of individual applications and help ensure that transactions are valid, properly authorized, and completely and accurately processed. These controls are discussed in more detail in AAM section 4200.64–79.
- *Physical controls.* These activities encompass the physical security of assets, including adequate safeguards over access to assets and records such as secured facilities and authorization for access to computer programs and data files and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on the circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.
- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties. Segregation of duties is often a problem for small business entities. See AAM section 4200.106–114 for further discussion and guidance.

**.49** Ordinarily, audit planning does not require you to understand the control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them. Your understanding of control activities is sufficient when you can identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests.

**.50 Information and Communication.** The information system relevant to financial reporting objectives—which includes the financial reporting information system—consists of the methods and records established to record, process, summarize, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets and liabilities.

**.51** The quality of system-generated information affects management's ability to make appropriate decisions in controlling the entity's activities and to prepare reliable financial statements. Thus, it is important that management receives the information they need to carry out their responsibilities and that the information is provided at the right level of detail.

**.52** An information system encompasses methods and records that—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording of their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

.53 The financial reporting information system is an integral part of an entity's information and communication system. Your consideration of the system should be made at the individual account and classes of transaction level. See AAM section 4200.89–.105 for additional guidance.

.54 *Monitoring.* Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions.

.55 Examples of ongoing monitoring activities include the following:

- Communications from external parties corroborate internally generated information or indicate problems. Customers implicitly corroborate billing data by paying their invoices. Conversely, customer complaints about billings could indicate system deficiencies in the processing of sales transactions. Similarly, bankers, regulators or other outside parties may communicate with the company on matters of accounting significance.
- External auditors regularly provide recommendations on the way internal control can be strengthened. Auditors may identify potential weaknesses and make recommendations to management for corrective action.
- Employees may be required to “sign off” to evidence the performance of critical control functions. The sign-off allows management to monitor the performance of these control functions.

## Application to Medium and Large Businesses

.56 The control environments of medium to large businesses may differ from those of small business entities in the following ways:

- The presence of a Board of Directors or audit committee
- The presence of an internal audit function
- More formalized policies and procedures

### Board of Directors or Audit Committee

.57 The control consciousness of a medium or large business is influenced significantly by the entity's board of directors and audit committee. In general, the board of directors should have an appropriate degree of management, technical, and other expertise. It should also have the necessary stature and mind-set so that it can adequately perform the necessary governance, guidance, and oversight responsibilities.

.58 Factors that influence the effectiveness of the board or audit committee include—

- Its independence from management.

- The experience and stature of its members.
- The extent of its involvement and scrutiny of activities.
- The appropriateness of its actions.
- The degree to which difficult questions are raised and pursued with management.
- Its interaction with internal and external auditors.

.59 The board of directors must be prepared to question and scrutinize management's activities, present alternative views and have the courage to act in the face of obvious wrongdoing. Because of this it is necessary that the board contain at least a critical mass of outside directors. The number should suit the entity's circumstances, but more than one outside director normally would be needed for a board to have the requisite balance.

## Internal Audit Function

.60 The internal audit function is established within an entity to monitor and evaluate the adequacy and effectiveness of internal control. For entities with an internal audit function, you ordinarily should make inquiries of appropriate management and internal audit personnel about the internal auditors'—

- Organizational status within the entity.
- Application of professional standards.
- Audit plan, including the nature, timing, and extent of audit work.
- Access to records and any limitations on the scope of their activities.

.61 After obtaining an understanding of the internal audit function you may either—

- Conclude that the internal auditors' activities are not relevant to the financial statement audit and give no further consideration to the internal audit function,
- Identify relevant internal auditor activities, but conclude that it would not be efficient to consider further the work of the internal auditors, or
- Decide that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of the audit. In this case, you should assess the competence and objectivity of the internal audit function as outlined in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU section 322).

.62 You may also request direct assistance from the internal auditors. If so, you should follow the guidance in paragraph 27 of SAS No. 65 (AU section 322.27).

## Formal Policies

.63 Medium and large businesses may communicate their policies in formal, written documents. For example, they may have a written code of conduct or human resource policies. The existence of formal policy documents is good, but as an auditor, your primary consideration is how the policies are implemented.

## Computer Applications

.64 Small business entities are typically characterized by the use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.



*.65 Jones Grocery has a stand-alone, state-of-the-art PC at its main store. One other store has a computer—an Apple Macintosh Mr. and Mrs. Jones' daughter used at college. The PC at the main store is used to run the accounting software, which is an off-the-shelf product developed specifically for independent grocers. The payroll is processed by an outside payroll service.*

*.66 In gaining an understanding of how computers are used in the business, you should consider the following:*

- The acquisition of hardware and software
- Physical access
- Logical access
- User controls over outsider service bureau applications

### Acquisition of Hardware and Software

*.67 Companies should take steps to ensure they have compatible hardware and software. The use of compatible software reduces the risk of error, since there will be no need to transfer data from one format into another. Even small businesses should have a coherent plan for the purchase of computer hardware and software. If the business is growing, management should plan for the upgrade of the processor, RAM, or hard-disk storage.*

*.68 Mr. and Mrs. Jones did not plan for the purchase of their computers. For several years, Mrs. Jones processed the accounting applications on an old 286 PC with limited RAM and hard-disk storage. When the Jones' daughter opened the second store, she brought with her the Apple Macintosh she had in college. At first, she tried to transfer data from her store to the main store, but the software had problems converting from the Apple format, so the procedure was abandoned. At a trade show, Mr. Jones discovered a computer software program specifically designed for independent grocers. He was impressed with the program and decided that it fit his needs perfectly. However, his hardware was out of date, and so in order to run the software, he upgraded his hardware. The new software supposedly is able to handle Apple-formatted data, and the company has plans to transfer data from the second store electronically. There are no plans to install computers at the other stores.*

*.69 As the auditor of Jones Grocery, you should use this understanding of the company computer system to help plan the audit. For example, they plan to transfer data from the Apple to the PC. What sort of errors might occur in the transfer? What steps has the client taken to prevent or detect those errors? You also know that stores three through eight are on a manual system. What types of errors might occur in a manual system? What is the risk that those errors will occur?*

*.70 Entities should also establish policies and procedures to mitigate the risk of computer viruses being introduced into their systems. Viruses can cause the loss of data and programs. A virus has the ability to attach itself to a program and infect other programs and systems. Although some viruses merely write messages across the screen, others can cause serious damage to disk files or shut down a network by replicating millions of times and filling all available memory or disk storage.*

*.71 Methods to prevent the introduction of viruses and to recover from a virus attack include the following:*

- Obtain recognized software from reputable sources and only accept delivery of the software in the manufacturer's sealed package.
- Make multiple generations of backups. A virus that is not detected initially may be copied onto more recent backup copies, while the older versions may not be infected.
- Prohibit the use of unauthorized programs introduced by employees.

- Prohibit downloading of untested software from sources such as dial-up bulletin boards.
- Use virus protection software to screen for virus infections.

### Physical Security

.72 Physical security—primarily backup and contingency planning—often is ignored by small businesses in a microcomputer environment. Poor backup procedures can result in the loss of important data that are very difficult, time-consuming and costly to recreate, if they can be recreated at all.

.73 Your clients should have established procedures for the periodic backup of data files and applications. Critical applications and files should be stored off-site with corresponding documentation in the event that on-site files become unavailable.

### Logical Access

.74 Logical access to computer applications and data files may not be formally or rigorously controlled in a small business. This leaves the company exposed to the risk that files could be inappropriately manipulated or unauthorized transactions entered into the system. For example, without logical access controls a user may be able to enter any or all sections of a general ledger or other financial module and perform file maintenance such as changing the address of an accounts receivable customer or data used to calculate payroll.

.75 Management should identify confidential and sensitive data for which access should be restricted. Mechanisms such as password control or the use of menus should be used to limit the access to that data.

.76 In a microcomputer environment, password control may be installed over the operating system using a shell program to prevent the user from accessing menu options of a program. Even if such a restriction exists, a sophisticated user can often bypass the shell by using a utility. Therefore, the use of utility programs should be controlled or monitored carefully.

### User Controls Over Computer Service Organization Applications

.77 Entities may use an outside computer service organization to process significant accounting information. Guidance on auditing entities that use computer service organizations is contained in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324).

.78 When using an outside computer service organization, most small businesses typically retain the responsibility for authorizing transactions and maintaining the related accountability. The computer service organization merely records user transactions and processes the related data. In these circumstances, the user (the small business) should maintain controls over the input and output to prevent or detect material misstatement.

.79 *Jones Grocery uses an outside computer service to process payroll. Time cards are gathered for each store and reviewed by the store manager before being sent to the main store. Mrs. Jones reviews the time cards for the store managers and checks to make sure all personnel have submitted time cards for the pay period. All other payroll transactions such as pay rates, withholdings, etc. are sent directly to Mrs. Jones. She forwards all information to the payroll service, which prepares the checks and produces a payroll register. Mrs. Jones reviews the register and checks for any obvious misstatements, before she distributes the checks.*

### Application to Medium or Large Businesses

.80 Medium and large businesses typically have more complicated computer processing systems than small businesses. They also tend to use the computer for a greater amount of processing. For example, a small

business may prepare customer invoices manually by looking up prices on a master price list. A medium size business may maintain master price information on a computer file and use the computer to generate packing slips, sales invoices, and reports of unmatched documents.

**.81** Medium and large businesses are also typically characterized by a separate management information services (MIS) department with formally defined job descriptions and responsibilities.

**.82** Instead of using off-the-shelf, unmodified software, the medium or large business will modify standard software or develop their own applications. Their software may be more complicated than that used by the small business; for example, they may use a database management system or telecommunications software.

**.83** Medium and large businesses often use a mainframe computer in conjunction with microcomputers or a local area microcomputer network. Information is frequently transferred between the mainframe and microcomputers that may be located on-site or at a remote location.

**.84** Control activities in a computerized environment generally comprise a combination of the following:

- User control activities
- Programmed control activities and manual follow-up
- Computer general control activities

**.85 *User Controls.*** User control activities are manual checks of the completeness and accuracy of computer output against source documents or other input. For example, an entity may have programmed procedures in a billing system that calculate sales invoice amounts from shipping data and master-price files. The entity may also have a procedure to manually check the completeness and accuracy of the invoices. In many systems, user controls relate only to the completeness of records and not to the accuracy of processing.

**.86 *Programmed Control Activities and Manual Follow-up Activities.*** Programmed control activities are those that are built into the computer processing program; for example, the generation of an exception report. However, an exception report is useless unless the client follows up on the items listed. Thus, in addition to understanding the nature of the programmed control activities, you also need to understand the related manual follow-up procedures.

**.87 *Computer General Control Activities.*** If computer general control activities operate effectively, there is greater assurance that programmed control activities are properly designed and function consistently throughout the period. You may plan to understand computer general control activities to provide evidence that—

- Programs are properly designed and tested in development.
- Changes to programs are properly made.
- Computer operations ensure the proper use of application programs and data files.
- Adequate access controls reduce the risk of unauthorized changes to the program and data files.

.88 The following table summarizes computer general control activities.

<i>Area</i>	<i>Control Objectives</i>	<i>Example Controls</i>
Program Development	<ul style="list-style-type: none"> <li>Controls ensure that new applications systems are suitably authorized, designed, and tested</li> </ul>	<ul style="list-style-type: none"> <li>Users are involved in the design and approval of systems</li> <li>Checkpoints where users review the completion of various phases of the application</li> <li>Development of test data and testing of the program</li> <li>User involvement in the review of tests of the program</li> <li>Adequate procedures to transfer programs from development to production libraries</li> </ul>
Program Changes	<ul style="list-style-type: none"> <li>Controls over changes to existing programs and systems ensure that modifications to application programs are suitably approved, designed, tested, and implemented</li> </ul>	<ul style="list-style-type: none"> <li>Same as systems development</li> <li>User involvement</li> <li>Adequate testing</li> <li>Adequate transfer activities</li> <li>Segregation of duties between programmers and production libraries</li> </ul>
Computer Operations	<ul style="list-style-type: none"> <li>Controls ensure that application programs are used properly and that proper data files are used during processing</li> </ul>	<ul style="list-style-type: none"> <li>Review of lists of regular and unscheduled batch jobs by operations management</li> <li>Use of menu-driven job control instruction sets</li> <li>Jobs executed only from the operator's terminal</li> <li>Adequate procedures for managing and backing up data and program files</li> </ul>
Access	<ul style="list-style-type: none"> <li>Controls should prevent or detect unauthorized changes to programs and to data files supporting the financial statements</li> </ul>	<ul style="list-style-type: none"> <li>Programmers have limited access to production programs, live data files, and job control language</li> <li>Operators have limited access to source code and individual elements of data files</li> <li>Users have access only to defined programs and data files</li> </ul>

## Obtaining an Understanding of Significant Account Balances and Transaction Cycles

.89 You should obtain an understanding of the classes of transactions in your client's operations that are significant to the financial statements. For less significant classes of transactions or account balances, an understanding of controls that have a pervasive effect on the organization is usually sufficient.

.90 For significant transactions and account balances you should obtain an understanding of—

- How those transactions are initiated.
- The records, supporting documents, computer media, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.

- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

**.91 *Initiating Transactions.*** You should understand how transactions are initiated. Some transactions may be initiated by customers or others outside the entity. Other transactions may be initiated from inside the organization by the use of a computer program; for example, calculating depreciation expense.

**.92** *At Jones Grocery, sales are initiated by customers and recorded in the cash register. At the end of the day the cash register totals are reconciled to the cash on hand, and a deposit is prepared for the day's receipts. On a weekly basis, the daily cash register tapes are batched for each store, forwarded to Mrs. Jones, and entered into the computer. The computer generates a sales register, a sales analysis report, and posts the sales totals to the general ledger.*

**.93 *Accounting Records, Supporting Documents, Computer Media, and Specific Accounts.*** In general you will want to identify the following for your client's significant accounts and transactions:

- Source documents
- The conversion of documents to computer media
- The nature of computer files that are further processed in the flow of information to the general ledger and the financial statements
- Accounts (subsidiary or general ledger master files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

**.94** Your client's accounting systems may create many documents, files, and reports that are useful for managing the organization, but you need to understand only those aspects that are relevant to the financial statements.

**.95** *At Jones Grocery, the sales analysis report described in AAM section 4200.92 is used for management information and analysis. The documents and reports relevant to the financial statements are the daily cash register tapes and the computer-generated sales register.*

**.96 *Accounting Processing.*** You should obtain an understanding of how your client processes accounting information—from the initiation of the transaction to its inclusion in the financial statements. This understanding should include how the computer is used to process data. Your understanding involves knowledge of the ways in which transactions are valued, classified, and summarized in data files, journals, or ledgers. For some transactions, there may be several significant processing activities and accounting records, including the use of computer programs. Other transactions may involve only limited processing activities performed manually.

**.97** *At Jones Grocery, the processing of inventory transactions (receipt of goods, sales, spoilage, etc.) involves several processing activities that are linked in the inventory module of the software package. On the other hand, recording depreciation expense is fairly simple. Fixed assets and the related depreciation are maintained on a computer spreadsheet, and each month, Mrs. Jones prepares a journal entry to record depreciation.*

**.98** Understanding the accounting processing also involves understanding the information used for processing and when processing occurs. For example, when considering the completeness assertion, you normally should understand whether transactions entered into the computer system are processed immediately or in batches and how frequently batches are processed.

**.99** The processing of accounting information may involve "end user computing." End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person.

.100 *Mrs. Jones developed and maintains the fixed asset spreadsheet that serves as the source document for her monthly depreciation expense journal entry.*

.101 In general, the product of end user computing may be used to—

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, the fixed-asset spreadsheet is separate from the Jones Grocery general ledger software package.
- Make significant accounting decisions. For example, a spreadsheet application may be used to generate information used to write down inventory.
- Accumulate footnote information. For example, a spreadsheet may be used to calculate the five-year debt maturity disclosure.

.102 Generally, end users have no training in the formal computer application development process. Accordingly, applications developed by end users are often inadequately tested, and the development process is often not documented. This situation can cause significant difficulties for an organization if the end user computing application is critical to making business or financial decisions.

.103 The access to end user computing applications may also be an audit concern. Many computer applications used in end user computing come with on-line systems that are capable of restricting users to specific applications, specific departments, or even specific fields. Often, however, these access restrictions facilities are not implemented.

.104 To address these concerns and to ensure the end user applications process data completely and accurately, you should generally look for control policies and procedures that—

- Require all significant end user applications to be adequately tested before use.
- Prescribe documentation standards for significant end user applications.
- Provide for adequate access controls to data.
- Provide a mechanism to prevent or detect the use of incorrect versions of data files.
- Provide for appropriate applications controls, for example, edit checks, range tests, or reasonableness checks.
- Support meaningful user reconciliations.

.105 *Financial Reporting Process.* When gaining an understanding of the financial reporting process, you may determine the extent of client procedures to prepare accounting estimates (when significant accounting estimates are called for) and information for significant disclosures. You also should understand the way in which general ledger information is summarized to determine how the amounts and disclosures are reported in the financial statements.

## Segregation of Duties and Management Override

.106 Small businesses are typically characterized by—

- A dominant owner-manager.
- A lack of segregation of duties.

.107 If your client has these characteristics, you should be sure to address the risks they pose to the entity.

.108 In general, duties should be divided, or segregated, among different people to reduce the risk of error or inappropriate actions. For instance, responsibilities for authorizing transactions, recording them, and handling the related assets should be divided.

.109 Even small businesses with only a few employees can usually parcel out responsibilities to achieve the necessary checks and balances. If that is not possible—as may occasionally be the case—direct oversight of the incompatible activities by the owner-manager can provide the necessary control. Thus, a dominant owner-manager may be a positive element in the design of internal controls.

.110 A dominant owner-manager may be a negative element in the design of internal control when he or she is able to override established policies and procedures.

.111 Management *override* should be distinguished from management *intervention*. Management *intervention* is discussed in AAM section 4200.22 and is described as the overrule of internal control for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the system.

.112 In contrast, management *override* is the overrule of internal control for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity's financial condition or compliance status.

.113 An owner-manager might override the control system for many reasons: to increase reported revenue, to boost market value of the entity prior to sale, to meet sales or earnings projections, to bolster bonus pay-outs tied to performance, to appear to cover violations of debt covenant agreements, or to hide lack of compliance with legal requirements. Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, and intentionally issuing false documents such as sales invoices.

.114 When gaining an understanding of internal control, you should assess the risk of management override.

## Assessing Internal Control Strengths and Weaknesses

.115 When obtaining your understanding of internal control, you should consider the *collective* effect of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by top management to overstate earnings.

.116 Internal control strengths may indicate account balances, transaction classes or assertions where you can assess control risk below the maximum. See additional guidance in AAM section 4600. Internal control weaknesses usually indicate areas where a primarily substantive audit approach is required. 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 unauditably, you should consider withdrawing from the engagement.

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[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—

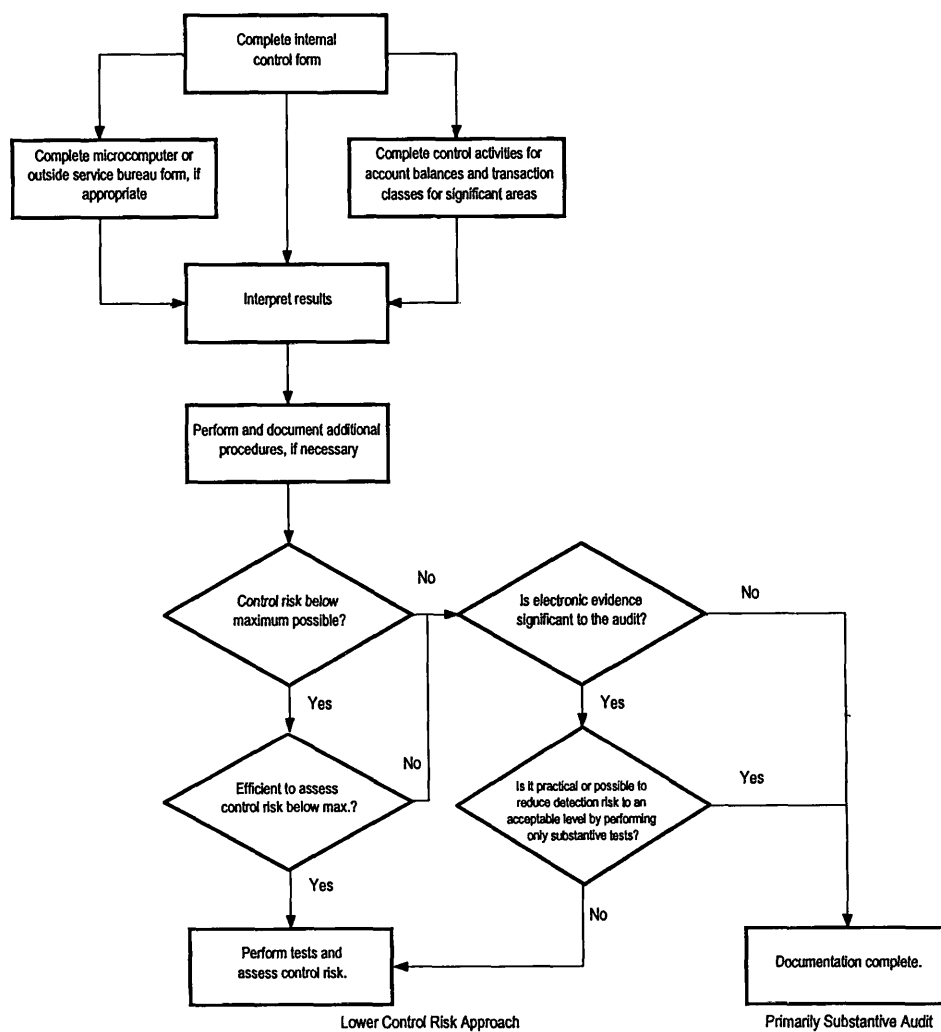
- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and

- 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.



## 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.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>A. Control Environment Factors</b>					
<i>Integrity and Ethical Values</i>					
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 <i>no</i> —					
• 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.	_____	_____	_____	_____	_____
<i>Commitment to Competence</i>					
9. Management has appropriately considered the knowledge and skill levels necessary to accomplish financial reporting tasks.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
10. Employees with financial reporting tasks generally have the knowledge and skills necessary to accomplish those tasks.	_____	_____	_____	_____	_____
<b><i>Management's Philosophy and Operating Style</i></b>					
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 <i>no</i> undue pressure to meet budget, profit, or other financial and operating goals.	_____	_____	_____	_____	_____
<b><i>Organizational Structure</i></b>					
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.	_____	_____	_____	_____	_____
<b><i>Assignment of Authority and Responsibility</i></b>					
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.	_____	_____	_____	_____	_____
<b><i>Human Resource Policies and Practices</i></b>					
21. The entity generally hires the most qualified people for the job.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
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>B. Other Internal Control Components With a Pervasive Effect on the Organization</b>					
<i>Risk Assessment</i>					
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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
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.	_____	_____	_____	_____	_____
<b>General Control Activities</b>					
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.	_____	_____	_____	_____	_____
<b>Information and Communication</b>					
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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
19. Information with accounting significance (for example, slow paying customers) is transmitted across functional lines in a timely manner.	_____	_____	_____	_____	_____
<b>Monitoring</b>					
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.

	<u>No</u>	<u>Yes</u>	<u>W/P Ref.</u>
<b>Microcomputers or Outside Service Bureaus</b>			
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—			
			_____



	<u>No</u>	<u>Yes</u>	<u>W/P Ref.</u>
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.

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## 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.

<u>Accounts, Transactions, and Assertions</u>	<u>Test of Controls Working Paper Reference</u>
<hr/>	<hr/>
<hr/>	<hr/>
<hr/>	<hr/>
<hr/>	<hr/>

### 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.





## 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

[illegible]

## II. Microcomputer Accounting Software

Describe the name and version of the microcomputer accounting software package.

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Which of the following modules have been implemented?

<i>Module</i>	<i>Module Implemented</i>		
	<i>Yes</i>	<i>No</i>	<i>N/A</i>
General ledger	<hr/>	<hr/>	<hr/>
Cash receipts	<hr/>	<hr/>	<hr/>
Cash disbursements	<hr/>	<hr/>	<hr/>
Accounts receivable	<hr/>	<hr/>	<hr/>
Accounts payable	<hr/>	<hr/>	<hr/>
Inventory	<hr/>	<hr/>	<hr/>
Fixed assets and depreciation	<hr/>	<hr/>	<hr/>
Other:	<hr/>	<hr/>	<hr/>
<hr/>	<hr/>	<hr/>	<hr/>
<hr/>	<hr/>	<hr/>	<hr/>
<hr/>	<hr/>	<hr/>	<hr/>

## III. Other Microcomputer Software

List the other software products used by the company.

<i>Name and Version</i>
<hr/>
<hr/>
<hr/>
<hr/>
<hr/>
<hr/>
<hr/>
<hr/>
<hr/>

## 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:

<i>Name and Version</i>
Operating system
Network software
Network management software
<hr/>

## 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.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>Acquisition of Hardware</b>					
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	_____	_____	_____	_____	_____
<b>Acquisition of Software</b>					
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.	_____	_____	_____	_____	_____
<b>Physical Security</b>					
12. The company has established procedures for the periodic back-up of files.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
13. Back-up procedures include multiple generations.	_____	_____	_____	_____	_____
14. Back-up files are stored in a secure, off-site location.	_____	_____	_____	_____	_____

**Logical Access**

15. Management has identified confidential and sensitive data for which access should be restricted.	_____	_____	_____	_____	_____
16. Procedures are in place to restrict access to confidential and sensitive data.	_____	_____	_____	_____	_____
17. Procedures are in place to reduce the risk of unauthorized transactions being entered into processing.	_____	_____	_____	_____	_____
18. The use of utility programs is controlled or monitored carefully.	_____	_____	_____	_____	_____

**General Operations**

19. Clear job descriptions exist for the use of microcomputers.	_____	_____	_____	_____	_____
20. Management periodically assesses the training needs for personnel who use microcomputers to process significant accounting information.	_____	_____	_____	_____	_____
21. Personnel who use microcomputers to process significant accounting information are adequately trained.	_____	_____	_____	_____	_____

**VI. Outside Computer Service Organizations**

This section should be used to document your understanding of how the company uses an outside computer service organization to process significant accounting information. Guidance on auditing entities that use computer service organizations is contained in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324).

1. List the name of the service organization and the general types of services it provides.

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2. Are the general ledger and other primary accounting records processed by an outside service organization? \_\_\_\_\_ Yes \_\_\_\_\_ No

If yes, describe the source documents provided to the service organization, the reports and other documentation received from the organization, and the controls maintained by the user over input and output to prevent or detect material misstatement.

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3. List the type and date of the most recent service auditor's report.

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[The next page is 4341.]

## AAM Section 4320

# *Financial Reporting Information Systems and Controls Checklist—Small Business*

### Revenue Cycle

#### Revenue, Accounts Receivable, and Cash Receipts

.01 This checklist may be used on any small business audit engagement when the revenue cycle is significant. Normally, the revenue cycle is significant in most small businesses.

.02 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the revenue cycle should be sufficient for you to understand—

- How cash and credit sales are initiated.
- How cash receipts are recorded.
- How sales and cash receipts are processed by the financial reporting information system.
- The accounting records and supporting documents involved in the processing and reporting of sales, accounts receivable, and cash receipts.
- The processes used to prepare significant accounting estimates and disclosures.

#### Interpreting Results

.03 This checklist documents your understanding of how internal control over the revenue cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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.

[illegible]

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>C. Estimates and Disclosures for Sales Transactions</b>				
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.	_____	_____	_____	_____
<b>II. Cash Receipts</b>				
<b>A. Initiating Cash Receipts Transactions</b>				
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>B. Processing Cash Received on Account</b>				
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.

**.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.

[illegible]

## 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.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Revenue Cycle</b>				
1. End user applications listed in paragraph .09 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

## Information Processed by Outside Computer Service Organizations

.11 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the revenue cycle.

.12 In the space below, describe the revenue cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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## Purchasing Cycle

### Purchasing, Accounts Payable, and Cash Disbursements

.13 This checklist may be used on any small business audit engagement where the purchasing cycle is significant. Normally, the purchasing cycle is significant for most small businesses.

.14 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the purchasing cycle should be sufficient for you to understand—

- How purchases are initiated and goods received.
- How cash disbursements are recorded.
- How purchases and cash disbursements are processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of purchases, accounts payable, and cash disbursements.
- The processes used to prepare significant accounting estimates and disclosures.

## Interpreting Results

.15 This checklist documents your understanding of how internal control over the purchasing cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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.

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	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Purchases and Accounts Payable</b>				
<b>A. Initiating Purchases and Receipt of Goods</b>				
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>B. Processing Purchases</b>				
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.	_____	_____	_____	_____



	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>C. Disclosures</b>				
15. Management has the information to identify vulnerability due to concentrations of suppliers (SOP 94-6).	_____	_____	_____	_____
<b>II. Cash Disbursements</b>				
<b>A. Initiating Cash Disbursements</b>				
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>B. Processing Cash Disbursements</b>				
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.

- [illegible]

		<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Purchasing Cycle</b>					
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.	_____	_____	_____	_____

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?

- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

## Inventory

### Inventory and Cost of Sales

.25 This checklist may be used on any small business audit engagement where inventory is a significant transaction cycle.

.26 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the inventory cycle should be sufficient for you to understand—

- How costs are capitalized to inventory.
- How cost is relieved from inventory.
- How inventory costs and cost of sales are processed by the financial reporting information system.
- The procedures used to take the physical inventory count.
- The accounting records and supporting documents involved in the processing and reporting of inventory and cost of sales.
- The processes used to prepare significant accounting estimates and disclosures.

### Interpreting Results

.27 This checklist documents your understanding of how internal control over the inventory cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Inventory and Cost of Sales</b>				
<b>A. Capturing Capitalizable Costs<sup>1</sup></b>				
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>B. Inventory Records</b>				
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.	_____	_____	_____	_____
<b>C. Physical Inventory Counts</b>				
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.	_____	_____	_____	_____
<b>D. Estimates and Disclosures</b>				
14. Management is able to identify excess, slow-moving, or obsolete inventory.	_____	_____	_____	_____

<sup>1</sup> 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.



## 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.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Inventory Cycle</b>				
1. End user applications listed in paragraph .33 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

## Information Processed by Outside Computer Service Organizations

.35 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the inventory cycle.

.36 In the space below, describe the inventory cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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## Financing

### Investments and Debt

.37 This checklist may be used on any small business audit engagement where investments or debt are a significant transaction cycle.

.38 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the financing cycle should be sufficient for you to understand—

- How investment decisions are authorized and initiated.
- How financing is authorized and captured by the financial reporting information system.
- How investment and debt transactions are processed by the financial reporting system.
- The accounting records and supporting documents involved in the processing and reporting of investments and debt.
- The processes used to prepare significant accounting estimates, disclosures, and presentation.
- How management classifies investments as either trading, available-for-sale, or held to maturity.

### Interpreting Results

.39 This checklist documents your understanding of how internal control over financing is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Investments</b>				
<b>A. Authorization and Initiation</b>				
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.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>B. Processing</b>				
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.	_____	_____	_____	_____
<b>C. Disclosures</b>				
10. Management identifies investments with off-balance-sheet credit risk for proper disclosure.	_____	_____	_____	_____
<b>II. Debt</b>				
<b>A. Authorization and Initiation</b>				
1. Financing transactions are authorized by the owner.	_____	_____	_____	_____
2. The owner assesses and understands all terms, covenants, restrictions of debt transactions.	_____	_____	_____	_____
<b>B. Processing and Documentation</b>				
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.	_____	_____	_____	_____
<b>C. Disclosure</b>				
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.





## 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.

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## Property, Plant, and Equipment

### Fixed Assets and Depreciation

.49 This checklist may be used on any audit engagement where fixed assets are a significant transaction cycle.

.50 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the property, plant, and equipment cycle should be sufficient for you to understand—

- How fixed asset transactions are authorized and initiated. (Additional information on the acquisition of fixed assets is documented on the Accounting Systems and Control Checklist for the Purchasing Cycle.)
- How fixed asset transactions and depreciation are processed by the financial reporting information system.
- The accounting records and supporting documents involved in the processing and reporting of fixed assets and depreciation.
- The processes used to prepare significant accounting estimates and disclosures.

## Interpreting Results

.51 This checklist documents your understanding of how internal control over property, plant, and equipment is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Fixed Assets and Depreciation</b>				
<b>A. Authorization and Initiation</b>				
1. Fixed asset acquisitions and retirements are authorized by the owner.	_____	_____	_____	_____
<b>B. Processing and Documentation</b>				
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.	_____	_____	_____	_____
<b>C. Disclosure and Estimation</b>				
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).	_____	_____	_____	_____



	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Property, Plant, and Equipment Cycle</b>				
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.

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### 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Payroll</b>				
<b>A. Initiating Payroll Transactions</b>				
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>B. Processing Payroll</b>				
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.	_____	_____	_____	_____



	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Payroll Cycle</b>				
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.

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[The next page is 4401.]



# AAM Section 4400

## *Illustrative Internal Control Forms—Medium to Large Business*

.01 The following are illustrative internal control forms you might use to document your understanding of internal controls sufficient to plan an audit. The illustrative questions are numbered merely for organizational purposes. The numbers are in no way intended to infer completeness or a preferred sequence. These forms may require modifications to meet the needs, preferences, and circumstances of individual firms and their clients. Whenever you use standardized forms, checklists, or questionnaires, you should recognize that important matters in a particular set of circumstances may not be covered.

### Instructions

.02 The forms in AAM sections 4410 and 4420 may be used on all audit engagements of medium to large businesses. For audits of small businesses, see AAM section 4300.

.03 In every audit, you should obtain an understanding of each of the components of internal control sufficient to plan the audit. These forms should be used as a tool in documenting your understanding of internal control, how internal control is designed, and whether controls have been placed in operation.

.04 These forms should be used in conjunction with other forms in the following circumstances:

- *Computer Applications Checklist—Medium to Large Business* [AAM section 4410]. To be used to document your understanding of how the entity uses computers 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.

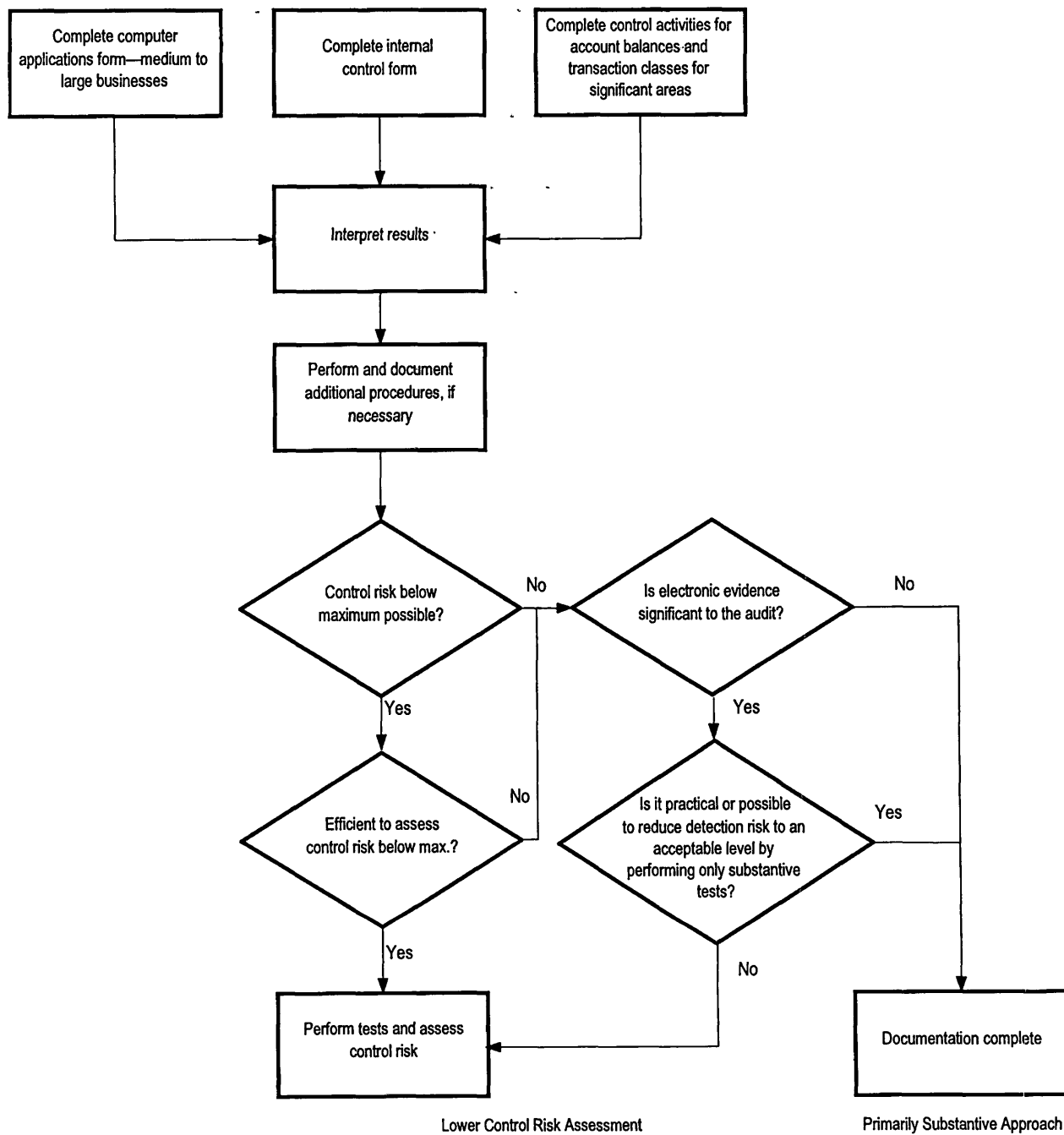
.06 If you plan a lower control risk assessment for certain assertions you are required to—

- 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.



## 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.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>A. Control Environment Factors</b>					
<i>Integrity and Ethical Values</i>					
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 <i>no</i> —					
• 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.	_____	_____	_____	_____	_____
<i>Commitment to Competence</i>					
9. Management has appropriately considered the knowledge and skill levels necessary to accomplish financial reporting tasks.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
10. Employees with financial reporting tasks generally have the knowledge and skills necessary to accomplish those tasks.	_____	_____	_____	_____	_____
<b><i>Board of Directors and Audit Committee</i></b>					
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.	_____	_____	_____	_____	_____
<b><i>Management's Philosophy and Operating Style</i></b>					
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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
21. There is relatively low turnover of key personnel (e.g., operating, accounting, data processing, internal audit).	_____	_____	_____	_____	_____
22. There is <i>no</i> 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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
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.	_____	_____	_____	_____	_____
<b><i>Human Resource Policies and Practices</i></b>					
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>B. Other Internal Control Components With a Pervasive Effect on the Organization</b>					
<b><i>Risk Assessment</i></b>					
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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
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.	_____	_____	_____	_____	_____
<b>General Control Activities</b>					
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 fire-proof 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.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
17. There is adequate segregation of duties among those responsible for authorizing transactions, recording transactions, and maintaining custody of assets.	_____	_____	_____	_____	_____
<b>Information and Communication</b>					
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.	_____	_____	_____	_____	_____
<b>Monitoring</b>					
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.

- 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.

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#### 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.

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**VI. Document Your Conclusion With Respect to Internal Controls**

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

\_\_\_\_\_

*[The next page is 4427.]*





## 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.)

	<u>Unmodified Commercial</u>	<u>In-House</u>	<u>N/A</u>
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.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>Acquisition of Hardware</b>					
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.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
3. The company's computer hardware is safely and properly installed.	_____	_____	_____	_____	_____
4. The company has standard, regular hardware maintenance procedures.	_____	_____	_____	_____	_____
<b>Acquisition of Software</b>					
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.	_____	_____	_____	_____	_____
<b>Program Development</b>					
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.	_____	_____	_____	_____	_____
<b>Program Changes</b>					
17. Users are involved in the design and approval of program changes.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
18. Program changes are thoroughly tested.	_____	_____	_____	_____	_____
19. Users are involved in the review of tests of the program changes.	_____	_____	_____	_____	_____
20. Adequate procedures exist to transfer changed programs from development to production libraries.	_____	_____	_____	_____	_____

**Logical Access**

21. Management has identified confidential and sensitive data for which access should be restricted.	_____	_____	_____	_____	_____
22. Procedures are in place to restrict access to confidential and sensitive data.	_____	_____	_____	_____	_____
23. Procedures are in place to reduce the risk of unauthorized transactions being entered into processing.	_____	_____	_____	_____	_____
24. The use of utility programs is controlled or monitored carefully.	_____	_____	_____	_____	_____
25. Procedures are in place to detect unauthorized changes to programs supporting the financial statements.	_____	_____	_____	_____	_____
26. Programmer access to production programs, live data files, and job control language is controlled.	_____	_____	_____	_____	_____
27. Operator access to source code and individual elements of data files is controlled.	_____	_____	_____	_____	_____
28. Users have access only to defined programs and data files.	_____	_____	_____	_____	_____

**Physical Security**

29. The company has established procedures for the periodic back-up of files.	_____	_____	_____	_____	_____
30. Back-up procedures include multiple generations.	_____	_____	_____	_____	_____
31. Back-up files are stored in a secure, off-site location.	_____	_____	_____	_____	_____

**Computer Operations**

32. Operations management reviews lists of regular and unscheduled batch jobs.	_____	_____	_____	_____	_____
33. Job control instruction sets are menu-driven.	_____	_____	_____	_____	_____
34. Jobs are executed only from the operator's terminal.	_____	_____	_____	_____	_____

#### IV. Outside Computer Service Organizations

This section should be used to document your understanding of how the company uses an outside computer service organization to process significant accounting information. Guidance on auditing entities that use computer service organizations is contained in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU section 324).

1. List the name of the service organization and the general types of services it provides.

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2. Are the general ledger and other primary accounting records processed by an outside service organization? \_\_\_\_ Yes \_\_\_\_ No

If "yes," describe the source documents provided to the service organization, the reports and other documentation received from the organization, and the controls maintained by the user over input and output to prevent or detect material misstatement.

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3. List the type and date of the most recent service auditor report.

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[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

## I. Revenue and Accounts Receivable

## A. Initiating Sales Transactions

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
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.	_____	_____	_____	_____

	<i>Personnel</i>	<i>N/A</i>	<i>No</i>	<i>Yes</i>
18. Someone other than the cashier takes periodic readings of the cash register and balances the cash on hand.	_____	_____	_____	_____
<b>B. Processing Sales Transactions</b>				
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.	_____	_____	_____	_____
<b>C. Estimates and Disclosures for Sales Transactions</b>				
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.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
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—





## 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.

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## Purchasing Cycle

### Purchasing, Accounts Payable, and Cash Disbursements

.13 This checklist may be used on any audit engagement of a medium to large business where the purchasing cycle is significant. Normally, the purchasing cycle is significant for most businesses.

.14 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the purchasing cycle should be sufficient for you to understand—

- How purchases are initiated and goods received.
- How cash disbursements are recorded.
- How purchases and cash disbursements are processed by the financial reporting information system.
- The accounting records and supporting documents involved in the processing and reporting of purchases, accounts payable, and cash disbursements.
- The processes used to prepare significant accounting estimates and disclosures.

## Interpreting Results

.15 This checklist documents your understanding of how internal control over the purchasing cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive

approach. 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Purchases and Accounts Payable</b>				
<b>A. Initiating Purchases and Receipt of Goods</b>				
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	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>B. Processing Purchases</b>				
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.	_____	_____	_____	_____
<b>C. Disclosures</b>				
18. Management has the information to identify vulnerability due to concentrations of suppliers (SOP 94-6).	_____	_____	_____	_____
<b>II. Cash Disbursements</b>				
<b>A. Initiating Cash Disbursements</b>				
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>B. Processing Cash Disbursements</b>				
5. Cash disbursements are posted to the general ledger on a timely basis.	_____	_____	_____	_____
6. Cash disbursements are posted to the accounts payable subsidiary ledger on a timely basis.	_____	_____	_____	_____
7. Standard journal entries are used to post cash disbursements.	_____	_____	_____	_____
8. Timely bank reconciliations are prepared or reviewed by the owner or manager or someone independent of the cash receipts function.	_____	_____	_____	_____

## End User Computing in the Purchasing Cycle

**.18** End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that amortizes premiums or discounts, and the information from the spreadsheet is the source of a journal entry.

**.19 The Computer Applications Checklist—Medium to Large Business** was used to document your understanding of computer applications operated by the company's MIS department. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the purchasing cycle to process significant accounting information outside of the MIS department.

**.20** You should obtain an understanding of any spreadsheet application, database, or separate computer system that has been developed by end users to—

- Process significant accounting information outside of the MIS-operated accounting application. For example, a spreadsheet accumulates non-routine purchases for batch processing.
- Make significant accounting decisions.
- Accumulate footnote information. For example, a database of vendors provides information for possible concentration of risk disclosures.

**.21** In the space provided below, describe how end user computing is used in the purchasing cycle. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (e.g., spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

[illegible]

## Procedures and Controls Over End User Computing

**.22 Answer the following questions relating to procedures and controls over end user computing related to the purchasing cycle.**

## Purchasing Cycle

<b>Personnel</b>	<b>N/A</b>	<b>No</b>	<b>Yes</b>
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1. End user applications listed in paragraph .21 of this form have been adequately tested before use.

\_\_\_\_\_

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	<hr/>	<hr/>	<hr/>	<hr/>
3. Access controls limit access to the end user application.	<hr/>	<hr/>	<hr/>	<hr/>
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	<hr/>	<hr/>	<hr/>	<hr/>
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	<hr/>	<hr/>	<hr/>	<hr/>

**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.

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**Inventory**

**Inventory and Cost of Sales**

.25 This checklist may be used on any audit engagement of a medium to large business where inventory is a significant transaction cycle:

.26 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the inventory cycle should be sufficient for you to understand—

- How costs are capitalized to inventory.
- How cost is relieved from inventory.
- How inventory costs and cost of sales are processed by the accounting system.
- The procedures used to take the physical inventory count.
- The accounting records and supporting documents involved in the processing and reporting of inventory and cost of sales.
- The processes used to prepare significant accounting estimates and disclosures.

## Interpreting Results

.27 This checklist documents your understanding of how internal control over the inventory cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Inventory and Cost of Sales</b>				
<b>A. Capturing Capitalizable Costs<sup>1</sup></b>				
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.	_____	_____	_____	_____

<sup>1</sup> 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.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
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>B. Inventory Records</b>				
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.	_____	_____	_____	_____
<b>C. Physical Inventory Counts</b>				
18. Inventory is counted at least once a year.	_____	_____	_____	_____
19. Physical inventory counters are given adequate instructions.	_____	_____	_____	_____
20. Inventory count procedures are sufficient to provide an accurate count, including steps to ensure—				
• Proper cut-off.	_____	_____	_____	_____
• Identification of obsolete items.	_____	_____	_____	_____
• All items are counted once and only once.	_____	_____	_____	_____



**D. Estimates and Disclosures**

21. Management is able to identify excess, slow-moving, or obsolete inventory.
22. Excess, slow-moving, or obsolete inventory is periodically written off.
23. Management can identify inventory subject to rapid technological obsolescence that may need to be disclosed under SOP 94-6.

<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

**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.

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### 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.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Inventory Cycle</b>				
1. End user applications listed in paragraph .33 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

### Information Processed by Outside Computer Service Organizations

.35 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of the client's use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the inventory cycle.

.36 In the space below, describe the inventory cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

## Financing

### Investments and Debt

.37 This checklist may be used on any audit engagement of a medium to large business where investments or debt are a significant transaction cycle.

.38 The purpose of this checklist is to document your understanding of controls for significant classes of transactions. Your knowledge of the financing cycle should be sufficient for you to understand—

- How investment decisions are authorized and initiated.
- How financing is authorized and captured by the accounting system.
- How management classifies investments as either trading, available-for-sale, or held to maturity.
- How investment and debt transactions are processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of investments and debt.
- The processes used to prepare significant accounting estimates, disclosures, and presentation.

### Interpreting Results

.39 This checklist documents your understanding of how internal control is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Investments</b>				
<b>A. Authorization and Initiation</b>				
1. Investment transactions are authorized by management.				

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
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.	_____	_____	_____	_____



## 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.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Financing Cycle</b>				
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.

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## 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Fixed Assets and Depreciation</b>				
<b>A. Authorization and Initiation</b>				
1. Fixed asset acquisitions and retirements are authorized by management.	_____	_____	_____	_____
<b>B. Processing and Documentation</b>				
2. The company maintains detailed records of fixed assets and the related accumulated depreciation.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
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.	_____	_____	_____	_____
<b>C. Disclosure and Estimation</b>				
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.





- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
  - Controls maintained by the entity to prevent or detect material misstatement in the input or output.
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## 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.

.65

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Payroll</b>				
<b>A. Initiating Payroll Transactions</b>				
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>B. Processing Payroll</b>				
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.	_____	_____	_____	_____



	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Payroll Cycle</b>				
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.

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[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.*

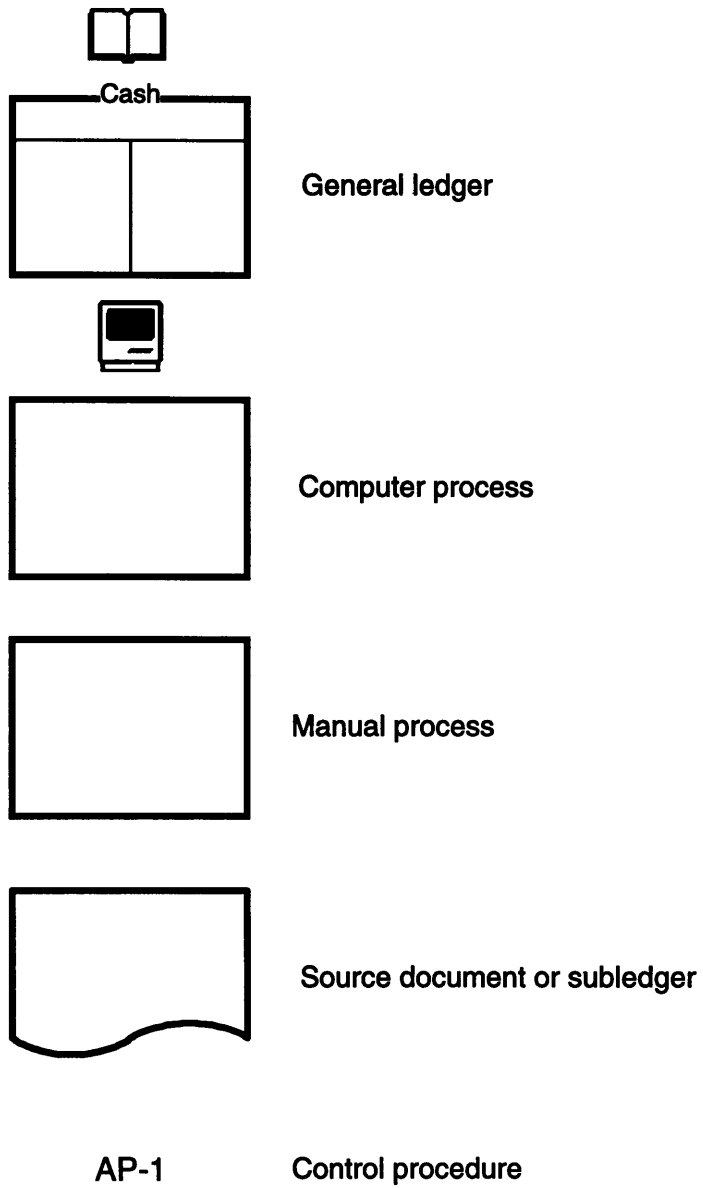
*.12 Once the checks are signed, they are coded and entered into the cash disbursements module of the accounting software package. The software updates the general ledger, the accounts payable subledger and aging, and produces a cash disbursements report. It also produces a cash management report that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

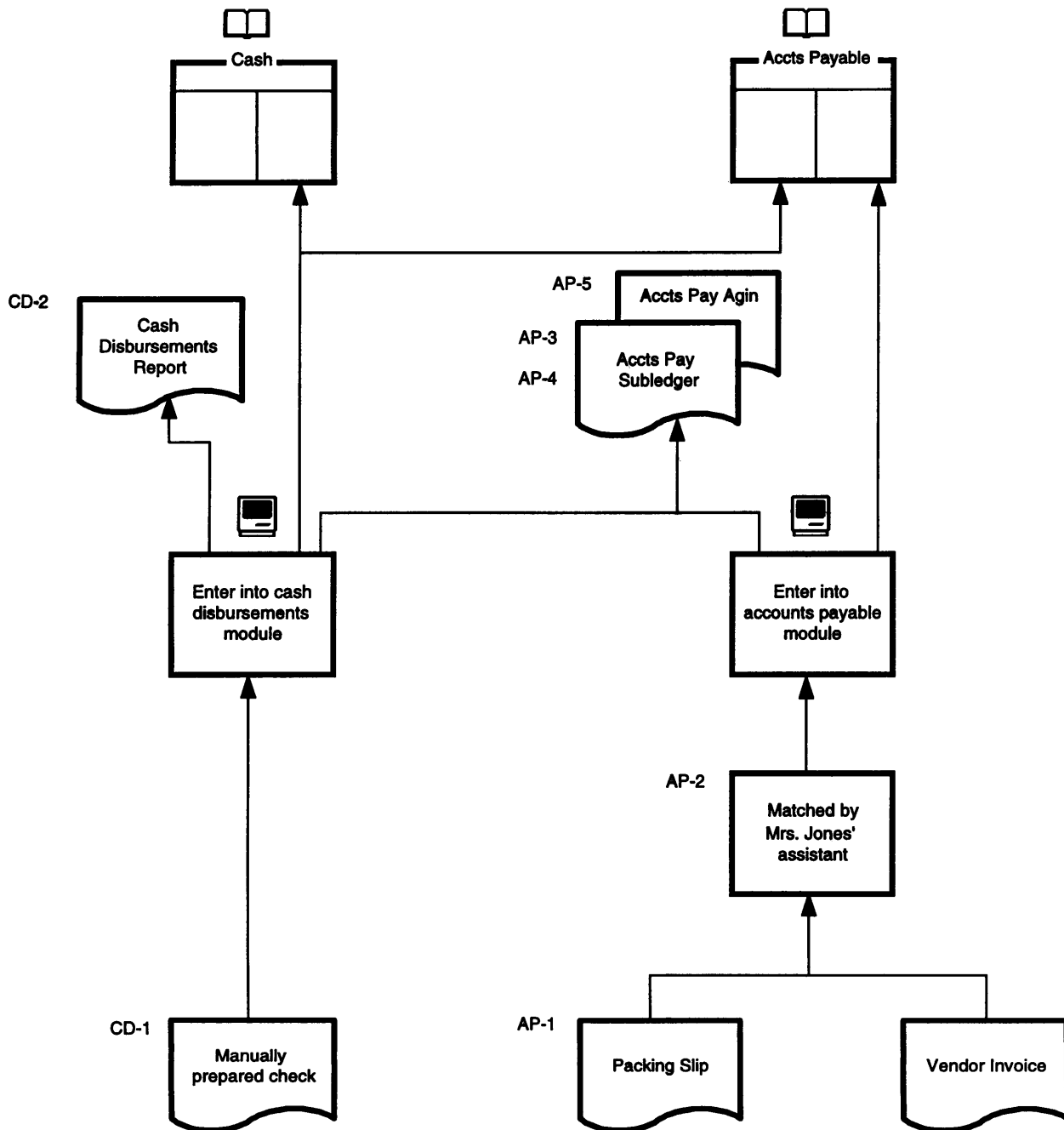
*.13 Monthly, the cash disbursements report is used to reconcile the cash accounts to the bank statements.*

## 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.*





**Jones Grocery  
Accounts Payable**

.15 The flowchart should be read from the bottom to the top. The initiation of transactions and related source documents are depicted at the bottom of the page. The processing is described as an upwards flow until the information reaches the general ledger at the top of the page.

.16 Following the flowchart is a brief memo describing the controls that are documented on the flowchart.

### Jones Grocery Accounts Payable

<u>Control No.</u>	<u>Description</u>
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.

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[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.

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#### 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.

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You may choose to assess control risk at the maximum either for audit efficiency purposes or because of ineffective controls. If you choose a primarily substantive audit because the controls are ineffective, you may have additional concerns about the auditability of the entity and other questions. Assuming you are able to overcome auditability concerns, you may respond by heightening the degree of professional skepticism, assigning more experienced staff, and changing the nature, timing, and extent of substantive procedures.

.04 Assessing control risk below the maximum involves—

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

.05 Controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular control component involved. The more direct the relationship between the control and the assertion, the more effective that control may be in reducing control risk for that assertion. For example, regular physical inventory count procedures are more likely to detect and correct misstatements than management's monitoring of gross-profit percentages.

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

*.07 Jones Grocery is a small chain of independent grocery stores in Anytown. Assume you have been the auditor of Jones Grocery for several years. During that time you have helped Mr. and Mrs. Jones design and implement the procedures used for the annual inventory count. The count itself is performed by an outside inventory count company that specializes in taking inventory at grocery stores. The outside company is supervised by Jones Grocery employees. Based on this knowledge of the controls for the physical inventory count, you may assess internal control risk below the maximum for the existence assertion related to inventory.*

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

## Performing Tests of Controls

.09 Tests of controls are directed toward the effectiveness of either—

- The design of the control, or
- The operation of the control.

.10 Tests directed toward the effectiveness of the *design* of controls are concerned with whether the control is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include—

- Tests performed in previous audits.
- Inquiries of appropriate personnel.
- Inspection of documents and reports.
- Observation of the application of specific controls.

.11 Tests directed toward the effectiveness of the operation of a control are concerned with how the control was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include—

- Tests performed in previous audits.

- Inquiries of appropriate personnel.
- Inspection of documents and reports indicating performance of the control.
- Observation of the application of specific controls.
- Reperformance of the application of the controls by the auditor.

.12 For controls for which documentary evidence exists, you may choose to examine the documents. For other controls (for example, segregation of duties) documentation may not exist. These controls often can be tested only by inquiry and observation.

.13 For example, you may decide to obtain evidence of the effectiveness of the design and operation of an entity's budgetary control methods. You could make inquiries of management about what variations from budget are investigated and the controls for reporting the reasons for these variances. Based solely on this inquiry, you would generally assess control risk at the maximum.

.14 The effectiveness of tests of controls may be increased by examining reports generated and asking more detailed question (such as about whether personnel follow up on budgets or about the timeliness of the investigations or the nature of the reports). By combining these inquiries with examination of written explanations of variances, the auditor can determine the operating effectiveness of these controls. This documentation may provide direct evidence for assessing the effectiveness of these controls in preventing or correcting misstatements in the financial statements.

.15 When performing tests of controls, caution is necessary. The tests cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of controls. Accordingly you should consider that—

- Evidence from prior audits may be affected by subsequent changes in internal control.
- Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of a specific control.
- Evidence from inquiry alone depends on the extent of the inquiries.
- Observation of employees in the performance of their duties may corroborate evidence obtained from other sources, but pertains only to the point in time at which the observation was made.
- Evidence from inspection of documents depends on the extensiveness of inspections made.

## **Evidence From Prior Audits**

.16 You can use evidence from prior audits to help support your assessment of control risk in the current audit. To evaluate the use of such prior period evidential matter for the current audit, you should consider—

- The significance of the assertion involved.
- The specific controls that were evaluated during the prior audits.
- The degree to which the effective design and operation of those controls were evaluated.
- The results of the tests of controls used to make those evaluations.
- The evidential matter about design or operation that may result from substantive tests performed in the current audit.
- The time that has elapsed since the performance of the tests of controls.

.17 When using evidence from prior audits, you should consider that changes—either in the controls themselves or in personnel—may have occurred subsequent to the prior audit. You should obtain current

evidence about whether changes have occurred subsequent to the prior audit, as well as the nature and extent of any changes. You should obtain evidential matter about changes in effectiveness of design and about changes in operating effectiveness.

.18 When changes in internal control between audits are relatively minor, evidential matter obtained in prior audits may provide assurance for the current audit. Conversely, changes may be so significant that evidential matter obtained in prior audits may provide limited or no assurance for the current audit.

.19 You should also obtain evidence in the current audit about the continued operating effectiveness of controls for which the design has remained unchanged. Decisions about the degree of assurance from prior audit evidence and about additional evidential matter needed in the current audit are affected by adverse conditions that may affect whether the controls are likely to continue to operate effectively, such as—

- Changes in the nature of transactions being processed or increases in volume.
- Changes in management attitudes or reduction of supervision.
- High turnover of employees.
- Increases in responsibilities or workloads of employees.
- The effect of related controls that reinforce the continued effective operation of the controls, such as the following:
  - Documented procedures manuals.
  - Close management supervision, including frequent communication and responsibility reporting.
  - Computer general control activities.

.20 You should obtain evidence in the current audit about the operating effectiveness of changed controls. If there are significant changes in design, prior evidence provides little, if any, assurance in the current audit.

## Computer Applications

.21 As described in AAM section 4200, your understanding of the control activities in the computerized environment generally comprise a combination of the following:

- User control activities
- Programmed control activities and manual follow-up activities
- Computer general control activities and manual follow-up activities

.22 User controls may provide evidence that the programmed control activities operate effectively, in which case you may choose to understand and test the user controls. If these controls are designed and operating effectively, these tests may support a lower control risk assessment.

.23 You might plan an audit strategy of testing programmed control activities and the related manual follow-up. For example, you might use computer-assisted audit techniques, such as generalized audit software or the processing of test data, to test the programmed control activities that produce an exception report. These tests provide evidence about the design and operation of programmed control activities; however, they do not provide evidence about the consistent application of the control activities. Evidence is provided only about the point in time when they are performed. 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.



.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.

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*[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**

<i>Transaction Class or Account Balance</i>	<i>Financial Statement Assertions</i>				
<i>Revenues</i>	<i>Existence/ Occurrence</i>	<i>Completeness</i>	<i>Rights/ Obligations</i>	<i>Valuation/ Allocation</i>	<i>Presentation/ Disclosure</i>
1. Use of prenumbered shipping documents.	✓	✓	N/A	N/A	N/A
2. Shipping documents matched with prenumbered invoices.	✓	✓	N/A	N/A	N/A
3. EDP functions segregated from users.	✓	✓	✓	✓	✓
4. Sales and accounts receivable postings are reconciled.	N/A	✓	N/A	✓	✓
5. Billing function segregated from collection function.	✓	✓	✓	✓	✓
6. Recording of sales journal and subsidiary ledger segregated.	✓	✓	✓	✓	✓
7. Monthly statements sent to customers.	✓	N/A	N/A	✓	N/A
8. Invoices are reviewed and verified.	N/A	N/A	N/A	✓	N/A
9. Accounts receivable aging is reviewed periodically.	N/A	N/A	N/A	✓	✓

**Initial Assessment of Control Risk:**      Moderate      Low      N/A      Moderate      Moderate

**Tests of Controls—W/P Ref.:**

**Final Assessment of Control Risk:**

.06

**ABC Company**  
**Assessment of Control Risk**  
**12/31/X6**

<i>Transaction Class or Account Balance</i>	<i>Financial Statement Assertions</i>				
<i>Purchases</i>	<i>Existence/ Occurrence</i>	<i>Completeness</i>	<i>Rights/ Obligations</i>	<i>Valuation/ Allocation</i>	<i>Presentation/ Disclosure</i>
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**

<i>Transaction Class or Account Balance</i>	<i>Financial Statement Assertions</i>				
<i>Inventory</i>	<i>Existence/ Occurrence</i>	<i>Completeness</i>	<i>Rights/ Obligations</i>	<i>Valuation/ Allocation</i>	<i>Presentation/ Disclosure</i>
1. Inventory listing including pricing and amounts maintained.	✓	N/A	N/A	✓	✓
2. Listing reconciled with general ledger periodically.	N/A	✓	N/A	✓	✓
3. Listing reconciled with actual count periodically.	✓	✓	N/A	✓	✓
4. Supporting documents reconciled with actual inventory received.	✓	✓	✓	N/A	N/A
5. Excess, slow moving, and obsolete inventory is identified and written off.	N/A	N/A	N/A	✓	N/A
6. Requisition documents are required for release of inventory.	✓	N/A	N/A	N/A	N/A

**Initial Assessment of Control Risk:**      Moderate      Low      Moderate      Low      Low

**Tests of Controls—W/P Ref.:**

**Final Assessment of Control Risk:**

.08

**ABC Company**  
**Assessment of Control Risk**  
**12/31/X6**

<i>Transaction Class or Account Balance</i>	<i>Financial Statement Assertions</i>				
<i>Financing</i>	<i>Existence/ Occurrence</i>	<i>Completeness</i>	<i>Rights/ Obligations</i>	<i>Valuation/ Allocation</i>	<i>Presentation/ Disclosure</i>
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**

<i>Transaction Class or Account Balance</i>	<i>Financial Statement Assertions</i>				
<i>Property, Plant, and Equipment</i>	<i>Existence/ Occurrence</i>	<i>Completeness</i>	<i>Rights/ Obligations</i>	<i>Valuation/ Allocation</i>	<i>Presentation/ Disclosure</i>
1. Fixed asset acquisitions and retirements are authorized by the owner.	✓	N/A	✓	✓	N/A
2. Detailed fixed asset records with accumulated depreciation are maintained.	N/A	N/A	N/A	✓	N/A
3. Records are reconciled to the general ledger periodically.	N/A	✓	N/A	✓	✓
4. Impairment of fixed assets is identified.	N/A	N/A	N/A	✓	N/A

**Initial Assessment of Control Risk:**      Moderate      Moderate      Moderate      Low      Moderate

**Tests of Controls—W/P Ref.:**

**Final Assessment of Control Risk:**



.10

**ABC Company**  
**Assessment of Control Risk**  
**12/31/X6**

<i>Transaction Class or Account Balance</i>	<i>Financial Statement Assertions</i>				
<i>Payroll</i>	<i>Existence/ Occurrence</i>	<i>Completeness</i>	<i>Rights/ Obligations</i>	<i>Valuation/ Allocation</i>	<i>Presentation/ Disclosure</i>
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:**

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[The next page is 5001.]



# AAM Section 5000

## Audit Approach and Programs

The material included in these sections on audit approach and programs is presented for illustrative purposes only. The comments, illustrative audit objectives, and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

This manual is a nonauthoritative kit of practice aids. Accordingly, these sections include minimal explanation and discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Users should also note that this manual does not deal with specialized industry problems; reference should be made to applicable AICPA Audit and Accounting Guides.

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# AAM Section 5100

## *Designing the Audit Program*

.01 The objective of an audit is to express an opinion on whether financial statements present fairly in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards. The procedures that the auditor plans to use to gather evidence are outlined in an audit program.

.02 Since the audit program describes the evidence-gathering steps to be used in the audit, it should be carefully designed. Designing an audit program involves three major considerations:

- a. Deciding *what* procedures to apply—the *nature* of audit tests
- b. Deciding *when* to apply the procedures—the *timing* of audit tests
- c. Deciding *which* items to apply the procedures to—the *extent* of audit tests

.03 Flowchart 1 presents an overview of the structure of the audit process. To design an audit program that is efficient and effective, the auditor should—

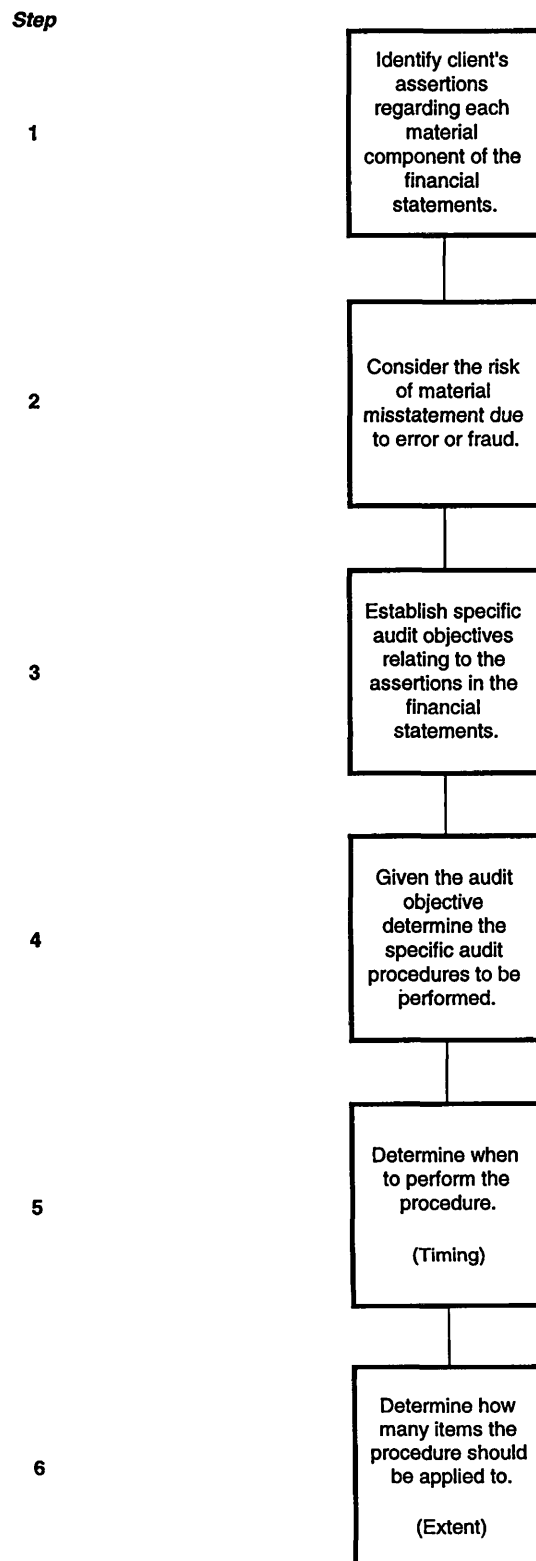
- a. Identify the client's assertions regarding each material component of the financial statements.
- b. Consider the risk of material misstatement due to error or fraud.
- c. Establish specific audit objectives relating to the assertions in the financial statements.
- d. Determine the audit procedures 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**



- 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

<u>Financial Statement Assertion</u>	<u>Illustrative Audit Objectives</u>
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

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.

.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.



.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 Practitioners sometimes accept management representations as sufficient audit evidence when completeness of recorded transactions cannot be substantiated. Management 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 management 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 management have been received, there is a limitation on the scope of the audit that precludes the auditor from issuing an unqualified opinion (SAS No. 85, *Management Representations*, paragraph 14 [AU section 333.14]).

## 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.

.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.

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[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.

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[The next page is 5301.]

# AAM Section 5300

## *Extent of Testing*

.01 Once an auditor decides what audit procedures to apply (the nature of the tests) and when to apply them (the timing of the tests), a decision must be made about how many items to apply the procedures to—that is, the extent of testing.

### Authoritative Standards\*

.02 SAS No. 39, *Audit Sampling* (AU section 350), addresses a variety of issues relating to the auditor's use of sampling in an audit engagement. However, SAS No. 39 does not always apply when the auditor is examining less than 100 percent of a population. There has been some confusion in practice over when SAS No. 39 applies.

### When SAS No. 39 Applies

.03 Audit sampling is only one of many tools used by auditors to obtain sufficient, competent evidential matter to support an opinion on financial statements. SAS No. 39 discusses design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used—

- a. In tests of controls in internal control to evaluate operating effectiveness from prescribed controls.
- b. In substantive tests of details of account balances and classes of transactions.
- c. In dual-purpose tests that assess control risk and test whether the monetary amount of a transaction is correct.

.04 The portion of SAS No. 39 pertaining to tests of controls applies when sampling techniques are used to assess control risk. The portion pertaining to substantive tests apply when sampling techniques are used to test details of transactions or balances.

.05 According to SAS No. 39, sampling occurs when the auditor tests less than 100 percent of a population *to make some conclusion about the population*. SAS No. 39 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control. Also, if the sampling populations are small, it is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

.06 In determining whether SAS No. 39 is applicable to circumstances in which an auditor examines less than 100 percent of the items making up an account balance or class of transactions, the auditor should consider the purpose of the test. If the auditor intends to project the test results to the entire account balance or class of transactions for the purpose of evaluating a characteristic of the balance or class, the guidance in SAS No. 39 should be followed. For example, if the auditor intends to examine selected sales invoices to draw

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\* The Audit and Attest Standards Division of the AICPA is developing an Auditing Practice Release (APR) to replace the AICPA Audit and Accounting Guide *Audit Sampling* (the Audit Sampling Guide). This APR is scheduled to be released during the third quarter of 1999.

a conclusion about whether sales are overstated, audit sampling as described in SAS No. 39 should be applied because the auditor intends to draw a conclusion about all sales. On the other hand, if the auditor selects several large sales invoices for certain audit tests and then applies analytical procedures to the remaining invoices, the auditor is not sampling according to SAS No. 39—the examination of the large items is not intended to lead the auditor to a conclusion about the other items. In that case, any conclusion about whether sales are overstated would be based on the combined results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed related to overstatement of sales.

.07 The auditor should remember that the way in which the population is defined can determine whether the requirements of SAS No. 39 apply. The auditor might choose to divide a single reporting line on the financial statements into several populations. For example, accounts receivable might be divided into wholesale receivables, retail receivables, and employee receivables. Each of these populations can be tested using a different audit strategy—some using audit sampling and others not. The sampling concepts in SAS No. 39 apply only to populations for which audit sampling is used. Use of audit sampling on one population does not mandate its use on remaining populations.

## Authoritative Guidance About the Application of Audit Sampling to Substantive Tests Provided by SAS No. 39

.08 There has been confusion in the accounting profession regarding what requirements are imposed by SAS No. 39. SAS No. 39 added the following seven specific provisions to professional standards.

- a. The concept that some items exist for which, in the auditor's judgment, acceptance of some sampling risk is not justified, and that these should be examined 100 percent (paragraph 21 [AU section 350.21]). This simply reminds the auditor that some of the items encountered in an examination of financial statements may be so significant individually or may have such a high likelihood of being in error or misstated that *all* such items should be examined.
- b. The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (paragraph 22 [AU section 350.22]). This indicates that audit efficiency can sometimes be improved by, for example, stratifying or segregating the items constituting a balance or class of transactions into groups based on individual dollar value or some other characteristic.
- c. A requirement that the auditor consider tolerable misstatement in planning audit sampling applications in the examination of account balances and classes of transactions (paragraph 18 [AU section 350.18]). This asks the auditor to consider, in the early stages of an audit, how much misstatement the auditor will be able to tolerate for each balance and class of transactions that is sampled, in combination with misstatements in other accounts, and still render an unqualified opinion on the financial statements. SAS No. 39 asks the auditor to consider tolerable misstatement and to recognize that it is one of the factors influencing sample size. There is no requirement to document or quantify tolerable misstatement.
- d. A requirement that the auditor select a sample that can be expected to be representative of the population (paragraph 24 [AU section 350.24]). Simply put, this means that each item in the population being sampled should have a *chance* of being selected, not necessarily an *equal chance* of being selected. This does not mean that the auditor is required to use a random or probability sample.
- e. A requirement that the auditor consider selected sample items to which the auditor is unable to apply planned audit procedures to determine their effect on the evaluation of the sample (paragraph 25 [AU section 350.25]). For example, sometimes the auditor may not be able to apply planned audit procedures to selected sample items because supporting documentation may be missing. If the auditor's



evaluation of the sample results would not be altered by considering those unexamined items to be in error, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class is materially in error, the auditor should consider alternative procedures that would provide sufficient evidence to form a conclusion.

- f. A requirement that the auditor project the misstatement results of the sample to the items from which the sample was selected (paragraph 26 [AU section 350.26]). Since the sample is expected to be representative of the population from which it was selected, misstatements found are also expected to be representative of the population. This merely asks the auditor to measure the likely misstatement in the population from which the sample was drawn and to consider it in reaching conclusions.
- g. A requirement that the auditor consider, in the aggregate, project misstatement results for all audit sampling applications and all known misstatements from nonsampling applications when evaluating whether the financial statements taken as a whole may be materially misstated (paragraph 30 [AU section 350.30]).

### Documentation Requirements in SAS No. 39

.09 SAS No. 39 contains no new or specific documentation requirements. However, the documentation standards set forth in the Statements on Auditing Standards dealing with documentation apply to audit sampling applications just as they apply to other auditing procedures. For example, SAS No. 22, *Planning and Supervision* (AU section 311), states that the auditor should prepare a written audit program and SAS No. 41, *Working Papers* (AU section 339), requires the auditor to prepare working papers recording the work that the auditor has done and the conclusions that the auditor has reached concerning significant matters. Thus, with regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Documentation might also include the definition of the population and the sampling unit, including: (1) how the auditor considered completeness of the population, (2) the definition of misstatement, (3) the method of sample selection, (4) a list of misstatements identified in the sample, (5) an evaluation of the result of the sampling application, and (6) conclusions reached by the auditor.

### Determining Extent of Testing in a Small Business Without Sampling

.10 Small businesses have certain characteristics that may influence the auditor's decision to use audit sampling. Because of the limited segregation of duties common in small businesses, auditors frequently choose to assess control risk at the maximum level, so generally the auditor of a small business will not have to consider tests of controls, including sampling of documentary evidence, to determine if controls are working as prescribed.

.11 For substantive testing, small businesses frequently have small populations of accounting data in both account balances and classes of transactions. Consequently, sampling may not be as useful since there may be large populations of data.

.12 SAS No. 39, paragraph 1 (AU section 350.01), defines audit sampling: "The application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class." This definition allows some alternative approaches to sampling to determine the extent of testing in a small business engagement. These alternatives, by not using audit sampling and thus eliminating the requirements of SAS No. 39, may provide a more effective and efficient audit approach for a small business engagement.

.13 These alternative approaches include:

- a. Procedures applied to 100 percent of a certain group (strata) of transactions or balances.
- b. Testing unusual items without applying procedures to the remainder of the population.

- c. Other tests that involve application of procedures to less than 100 percent of the items in the population without drawing a conclusion about the entire account or class of transactions.

.14 The auditor should decide what audit procedures to perform to meet the established audit objectives. Once this decision is made, the auditor needs to determine the extent of testing.

.15 An effective and efficient approach to determining the extent of testing in a small business engagement is shown in flowchart 1. This approach involves four important steps.

### Identification of Individual Items to Be Examined

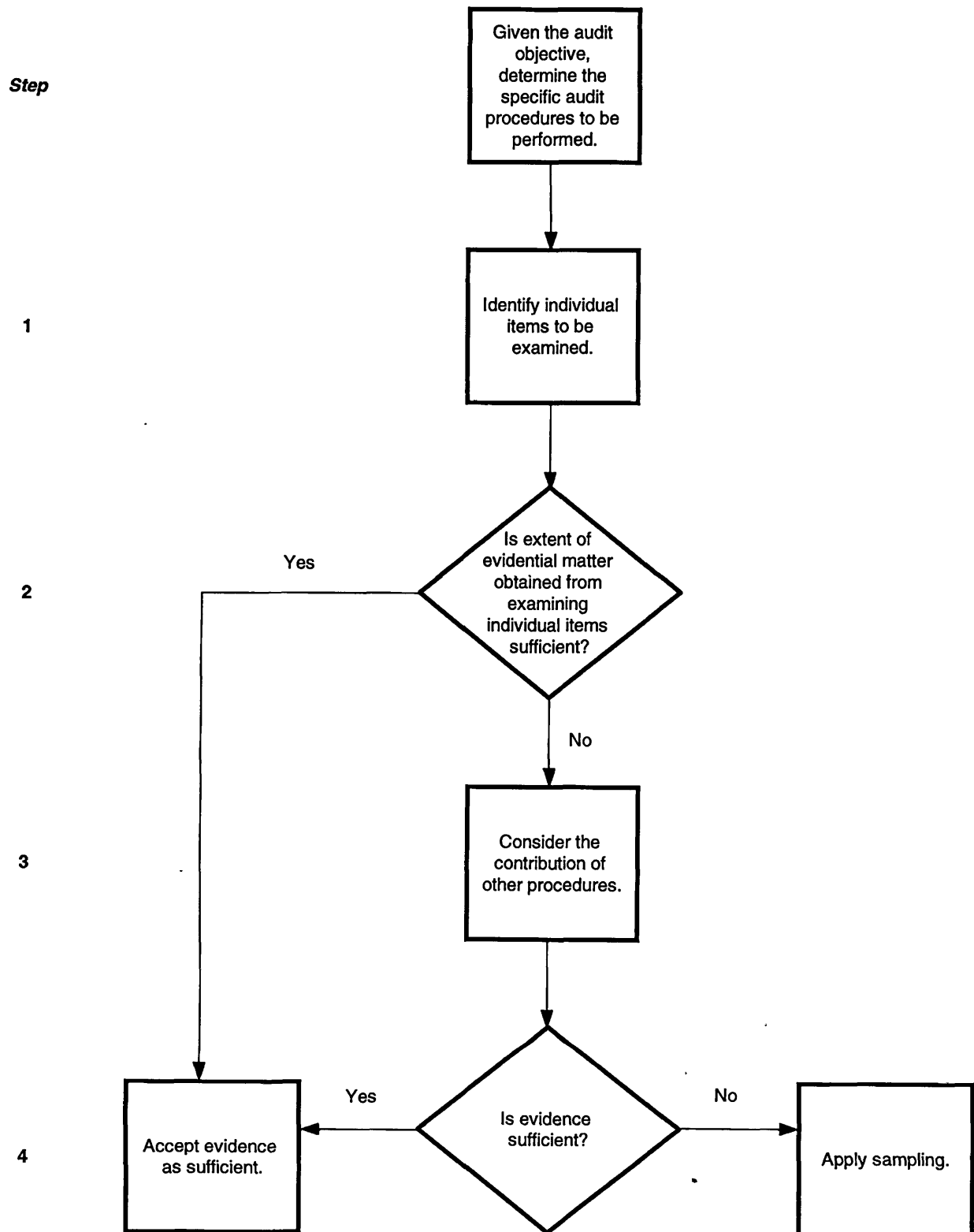
.16 An auditor should apply professional judgment in determining which individual items in an account balance or class of transactions need to be examined. In evaluating individual items, the auditor should consider factors such as size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

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

<i>Number of Accounts</i>	<i>Balances</i>	<i>Total Accounts</i>
4	\$100,000 or more	\$ 625,000
7	\$25,000–99,999	375,000
62	\$1–24,999	300,000
<u>73</u>		<u>\$1,300,000</u>

In this case, if the eleven largest accounts are confirmed by the auditor, most of the accounts receivable balance is supported (\$1,000,000 out of \$1,300,000, or 77 percent). Also, the auditor may decide to confirm the receivables that have unusual characteristics (for example, receivables with either large credit balances or those that are very delinquent).

**Flowchart 1**  
**An Audit Sampling Approach for a Small Business**



## Is Extent of Evidential Matter Obtained Sufficient?

.18 Some factors which have been identified in SAS No. 39 in evaluating the sufficiency of evidential matter obtained in tests of details for a particular account balance or class of transactions are:

- a. The individual importance of the items examined. If the items examined, account for a high percentage of the total population, then the auditor may be reasonably assured that there is an acceptably low risk of an undetected misstatement.
- b. The nature and cause of misstatements. If during the course of the audit, misstatements are discovered, those misstatements should be evaluated to determine if they are due to differences in principle or in application, are errors or fraud 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 due to fraud this would require a broader consideration of the possible implications than would the discovery of an error.
- d. The characteristics of the sample to the population. The auditor may obtain some knowledge of the types of items in the population if the characteristics in the sample are similar in nature and the same controls are followed for processing the transactions.

.19 If an auditor has examined a substantial number of individual amounts and found no evidence of problems from the other procedures performed—and the remaining population totals less than an amount that would be material to the financial statements—there is often no need to sample the remaining population. Otherwise, the auditor should extend tests to the remaining population unless an alternative approach can be justified.

## Consider Contribution of Other Procedures

.20 The auditor should also consider whether other evidence obtained contributes to conclusions regarding the account balance or class of transactions. The auditor often considers the contribution of other procedures at the same time the extent of evidential matter obtained from examining individual items is considered.

.21 The auditor may use a combination of analytical procedures and substantive tests of details to support an opinion on the financial statements. A small business audit does not typically include assessing control risk at less than the maximum level, so the auditor would rely primarily on analytical procedures and other substantive tests of details. In deciding whether other audit procedures make a contribution, the auditor should consider whether they support the audit objectives in the area, whether they indicate potential problems, and whether the evidence is consistent with the previous evidence obtained.

.22 In considering the contribution of other procedures, the auditor should use professional judgment in determining whether an unqualified opinion can be given without performing additional tests in the form of audit sampling.

## Evaluation of Sufficiency of Evidence

.23 There are three factors that the auditor may consider in evaluating the sufficiency of audit evidence obtained from examining individual items and contributed by other procedures, and in determining whether the remaining items in the population should be tested.

.24 First, the auditor should consider whether the dollar amount of the remaining population is equal to or greater than an amount that would be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional testing by sampling is necessary. Second, the

auditor should consider the degree of risk involved (that is, how susceptible the account is to misstatement, and whether there have been problems with this area in prior audits). Third, the auditor should consider the sufficiency of all the audit evidence obtained so far (the extent of evidential matter obtained by testing individual items along with the contribution of other procedures).

## Audit Sampling for Tests of Controls

.25 SAS No. 39 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This section provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

- a. *Determine the objective of the test.* The objective of a test of control is to determine whether particular controls are being applied as prescribed. Audit sampling for tests of controls is generally appropriate when application of the controls leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant controls were applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.
- b. *Define the deviation conditions.* A deviation condition is a situation that indicates that the controls were not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (e.g., the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Adequate performance of controls consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed procedure requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the procedure for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as "a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"
- c. *Define the population.* The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of control activities designed to determine if all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. However, sometimes the results of tests performed at an interim date may be sufficient to generalize about the population for the entire period. In determining whether interim tests are sufficient, the auditor should consider the results of the tests, responses to inquiries concerning the remaining period, the length of the remaining period, the nature and amounts of the transactions or balances involved, and related evidence obtained from the tests of balances. If controls have been changed during the year, the auditor will often decide that it is efficient to only test the new controls.

For sample results to be reliable, the sample must be selected from the complete population. Completeness of the population can be determined by either physical or numerical control. Normally, the auditor can establish the completeness of the population by inspecting the documents to see that it appears that they have all been accounted for.

- d. *Determine the method of selecting the sample.* Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection should generally be used when statistical sampling is being applied. When nonstatistical sampling

is applied, random-number sampling, systematic sampling, and haphazard sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at AAM section 5300.61.

- e. *Determine the sample size.* Sample sizes for tests of controls are affected by (a) the risk of assessing control risk too low, (b) the tolerable deviation rate, (c) the expected population deviation rate, and (d) any effects of small population sizes.

Guidance for determining sample size when performing nonstatistical sampling begins with AAM section 5300.28. A description of statistical sampling begins with AAM section 5300.31.

- f. *Perform the sampling plan.* Once the sample has been selected, the auditor should examine each item for evidence of performance of the controls. If the auditor selects an item that is unused (e.g., a voided document), the auditor should select another item, at random. However, the auditor should make sure that the item really represents an unused item. If the document is valid, but cannot be found, the item should be treated as a deviation in evaluating the sample results.
- g. *Evaluate the sample results.* Guidance for evaluating nonstatistical sampling results begins with AAM section 5300.30 and guidance for evaluating statistical sampling results begins with AAM section 5300.32.
- h. *Document the sampling procedure.* The audit working papers should document the following matters:
- The objectives of the test.
  - A description of the deviation conditions.
  - The acceptable risk of assessing control risk too low.
  - The tolerable deviation rate.
  - The expected deviation rate.
  - The sample results, including the disposition of any deviations found.
  - The effect of the results on the auditors assessed level of control risk.

**.26 Factors Affecting Sample Sizes for Tests of Controls.** Sample sizes for tests of controls are affected by the following factors:

- a. *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the sample supports a lower level of control risk than is in fact the case. Decreasing the risk of assessing control risk too low will increase the sample size.
- b. *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. As the expected population deviation rate increases, the sample size will increase.
- c. *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure that the auditor is willing to accept without increasing the assessed level of control risk. Higher tolerable deviation rates will permit smaller sample sizes.
- d. *Population size.* Populations over 500 items have little or no effect on sample size. For populations under 500 in size, the auditor may slightly reduce the size of the sample.

.27 The effects of these factors may be summarized as follows:

<i>Factor</i>	<i>Effect on Sample Size</i>
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:

<b>Controls Testing Nonstatistical Sample Size Selection Table</b>	
<i>Assessed Level of Control Risk</i>	<i>Sample Size</i>
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:

<i>Deviations (Expected or Actual)</i>	<i>Assessment of Control Risk</i>		
	<i>Slightly Below Maximum</i>	<i>Moderate</i>	<i>Low</i>
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:

<i>Planned Assessed Level of Control Risk</i>	<i>Tolerable Rate</i>
Low	2%–7%
Moderate	6%–12%
Slightly below the maximum	11%– 20%
Maximum	Omit test

- *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. The auditor's expectations may be based on prior years' experience with the client, or experience with similar clients. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.
- d. *Determine the appropriate sample size.* Sample sizes are found in the tables in AAM section 5300.33 and .34. The table in AAM section 5300.35 is designed for a risk of assessing control risk too low of 5 percent, and the table in AAM section 5300.36 is designed for a 10 percent risk of assessing control risk too low. With the tolerable deviation rate and the expected deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.
  - e. *Randomly select the sample from the population.* The section beginning at AAM section 5300.61 describes the methods that may be used to select a random sample.
  - f. *Perform the audit procedures to identify deviations in the sample.*
  - g. *Calculate the statistical results.* Using the tables in AAM section 5300.35 and .36 or the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.



- h. Reassess the level of control risk.* If the actual deviation rate in the sample is higher than that specified in determining the sample, the sample results will not support the auditor's planned assessed level of control risk. In these situations, the auditor should increase the assessed level of control risk. The auditor should also consider the causes of the deviations found, and whether they have implications for other audit areas.
- i. Document the Sampling Procedures.* The audit working papers should document the matters set forth in AAM section 5300.25 (Item No. 8).

.33

**Statistical Sample Sizes for Testing Controls  
Five Percent Risk of Assessing Control Risk Too Low  
(with number of expected deviations in parentheses)**

Expected Population Deviation Rate	Tolerable Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

\*Sample size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide *Audit Sampling*.

**Note:** This table assumes a large population.

.34

**Statistical Sample Sizes for Testing Controls**  
**Ten Percent Risk of Assessing Control Risk Too Low**  
**(with number of expected deviations in parentheses)**

Expected Population Deviation Rate	Tolerable Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	144(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

\*Sample size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide *Audit Sampling*.

**Note:** This table assumes a large population.

.35

**Statistical Sample Results Evaluation**  
**Table for Tests of Controls**  
**Tolerable Deviation Rate at Five Percent Risk of Assessing Control Risk Too Low**

Sample Size	Actual Number of Deviations Found										
	0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.8	*	*	*	*	*	*	*
45	6.5	10.2	5.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	5.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	5.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	5.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	5.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

\*Over 20 percent.

Derived from AICPA Audit and Accounting Guide *Audit Sampling*.

**Note:** This table presents upper limits as percentages. This table assumes a large population.

.36

**Statistical Sample Results Evaluation**  
**Table for Tests of Controls**  
**Tolerable Deviation Rate at Ten Percent Risk of Assessing Control Risk Too Low**

Sample 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	14.1	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

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\* 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 significant items, is immaterial, no testing of the remaining balance is necessary.

.39 The decision to sample, or not to sample, should be documented in the *working papers*.

.40 Selecting all individually significant items is not considered a sampling application. Items such as large receivables are usually examined individually. Procedures used for examining such items should ordinarily be the most reliable under the circumstances, such as positive confirmation requests.

.41 When planning a sampling application for tests of balances, the in-charge should consider the financial statement assertions and audit objectives and their relationship to populations selected. For example, understatements cannot be detected by sampling recorded amounts; instead, units from populations of all existing transactions must be selected.

.42 The following is an approach to nonstatistical sampling for tests of balances.

- a. Determine the sampling population by identifying and deducting the individually significant items.
- b. Determine the sample size by considering the following factors:
  - The amount of tolerable misstatement.
  - The assessed level of inherent and control risk for the assertions being tested.
  - The risk that other substantive procedures (e.g., analytical procedures) will fail to detect a material misstatement.
  - Variations within the population.
- c. Select the sample.
- d. Perform the test procedure.
- e. Evaluate the results.
  - Project the misstatement.
  - Consider sampling risk.
  - Consider qualitative aspects of the test results.

.43 Sample selection methods should produce representative samples and may include random selection, systematic selection, or haphazard selection methods. Care should be taken to avoid bias, however, when a haphazard selection method is used. AAM section 5300.61 describes these sample selection methods.

.44 **Determine the Sample Size for Tests of Balances.** Sample sizes for tests of balances are affected by the following factors:

- *Tolerable misstatement.* As the amount of tolerable misstatement increases, the sample size decreases. Conversely, larger sample sizes are required to compensate for a smaller amount of tolerable misstatement.
- *Assessed level of inherent and control risk.* As the combined level of inherent and control risk increases, the sample size increases.
- *The risk that other substantive procedures will fail to detect a material misstatement.* As the risk that other substantive procedures will fail to detect a material misstatement increases, the sample size increases. This risk is determined by considering the effectiveness of these procedures.
- *Variations within the population.* Sample sizes are smaller when the sampling population is stratified into homogeneous groups. Larger sample sizes are usually required to obtain a representative sample from sampling populations with high variations.

.45 Illustration 1 summarizes the impact of the factors above on sample size planning.

.46 *Nonstatistical Sampling Approaches.* At the direction of the engagement partner, either of the following nonstatistical approaches can be used for selecting tests of balances sample sizes:

- Judgmental method.
- Model approach.

### Illustration 1

#### Factors Influencing Sample Sizes for Substantive Tests of Balances

<u>Factor</u>	<u>Conditions Leading to:</u>	
	<u>Smaller Sample Size</u>	<u>Larger Sample Size</u>
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*.



.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:

<i>Sampling Population</i>		<i>Basic Allowance (Tolerable Misstatement)*</i>		<i>Assurance Factor</i>		<i>Initial Sample Size</i>
\$ _____	+	\$ _____	×	_____	=	\$ _____

.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).

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\* Amount should be two-thirds of overall materiality limit.

.59 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if \$200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is \$2 (\$200/100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 25,000 items) by the average difference of \$2 for each sample item. The estimate of misstatement in the population is \$50,000 (25,000 × 2).

.60 If the projected misstatement is less than tolerable misstatement for the account balance, consideration must be given to the risk that actual misstatement exceeds the amount of tolerable misstatement. If the projected misstatement is less than 1/3 of tolerable misstatement, it is generally safe to conclude that sampling risk is sufficiently low. If it is greater than 1/3, consideration should be given to performing additional tests of the account.

## Selecting Samples

.61 SAS No. 39 permits random number selection, systematic selection with or without random starts and haphazard selection methods for nonstatistical sampling. Block sampling is not acceptable. A random number selection method should be used for statistical sampling.

.62 Random-based selection methods can be applied using random number tables or computer or calculator programs.

.63 To use a random number table:

- a. Assign each element in the population a unique address that corresponds to the random number table.
- b. Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
- c. Place a pencil on a page to determine a random starting point.
- d. Modify the population numbers to the smallest possible number of digits to reduce discards.

.64 The procedure for using a program or calculator to generate random numbers varies with the programs. However, these techniques generally require the auditor to provide the smallest and largest item numbers, and the number of sample items needed.

.65 Systematic sampling requires the calculation of an interval. An interval is determined by dividing the population size by the number of sample units desired. For example:

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

.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.

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[The next page is 5401.]

## AAM Section 5400

### *Illustrative Audit Program for Corporations*

.010 The audit programs contained in this section have been designed to provide substantive evidence (when combined with appropriate planning and with appropriate tests of controls) that is sufficient to support the assertions in the client's financial statements. The programs should be modified to reflect overall engagement risk, risks of potential misstatements, the results of analytical procedures, and the selection of the most cost-beneficial audit approaches and procedures.

.011 The programs address the financial statement assertions discussed in SAS No. 31, *Evidential Matter*, 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

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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## 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 11,300.23.)   | _____ | _____ | _____ |
| 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.  | _____ | _____ | _____ |

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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>B. Conclusion of Audit</b>			
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	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
(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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
8. Obtain written representation from management of the client (SAS No. 85 [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.	_____	_____	_____
<hr/> <b>Note:</b> 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. <hr/>			
15. Determine that any required communications in accordance with SAS No. 61, <i>Communication With Audit Committees</i> (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			

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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 \_\_\_\_\_



### 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.	

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\* **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**

<i>No.</i>	<i>Action</i>	<i>Sign-Off or N/A</i>
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).	

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.030

<i>Done by</i>	<i>Date</i>	<i>W/P Ref.</i>
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## 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


	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<hr/> <b>Note:</b> 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. <hr/>			
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, includ-			

ing 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

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

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.

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**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.

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- |   | <u>Done<br/>by</u> | <u>Date</u> | <u>W/P<br/>Ref.</u> |
|---|--------------------|-------------|---------------------|
| 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

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**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.

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	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.).

\_\_\_\_\_



	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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). | _____ | _____ | _____ |

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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			

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<p><b>Note:</b> 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.</p>			
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	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>C-3. Purchases, Accounts Payable, and Disbursements—Evaluation of Tests of Controls</b>			
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.

<b>D-1. Payroll—Understanding and Risk Assessment</b>			
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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<hr/>			
<b>Remember:</b> 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.			
<hr/>			
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.)

_____	_____	_____
_____	_____	_____
_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.)	_____	_____	_____



	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.) | _____ | _____ | _____ |
|---|-------|-------|-------|

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<hr/> <b>Remember:</b> 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. | _____ | _____ | _____ |
|--|-------|-------|-------|

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<b>Note:</b> 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	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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 _____	_____	_____	_____
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Reviewed by _____	_____	_____	_____
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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  
ByDateW/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)

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**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.

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**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

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>[A] B. Substantive Analytical Procedures</b>			
<b>[B] [C] [D] 1. Compare account balances with preceding year's balances (or expected balances) and investigate any significant deviations from expected balances.</b>			
	_____	_____	_____
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.	_____	_____	_____
<b>C. Cash in Banks—Detailed Tests</b>			
<b>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>			
	_____	_____	_____
<b>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.</b>			
	_____	_____	_____
<b>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:</b>			
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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			



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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 incompleting 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 inquiries 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.	_____	_____	_____
<b>D. Cash Funds and Petty Cash—Detailed Tests</b>				
	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			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
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#### E. Additional Procedures (if any)

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>F. Section Completion</b>			
1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for cash balances, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for cash balances.	_____	_____	_____
2. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
_____	_____	_____	_____
Done by			
_____	_____	_____	_____
Reviewed by			

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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#### 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)

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**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.

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>Procedures:</b>			
<b>A. Preliminary Procedures</b>			
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>[A] B. Substantive Analytical Procedures</b>			
<b>[B][C][D]</b>			
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).	_____	_____	_____
<b>C. Detailed Tests</b>			
<b>A B C E</b>			
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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 crossfoot 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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, 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:			
	a. Inquiry of management as to:			

\* See the appendix to this audit program for nonauthoritative guidance on auditing management's ability and intent in purchasing and holding securities.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(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.	_____	_____	_____
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).	_____	_____	_____



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
	19. Evaluate whether management has considered relevant information in determining whether a decline in fair value below the amortized cost basis of investments is other than temporary.	_____	_____	_____
<p><b>Note:</b> Examples of factors that may indicate an other-than-temporary impairment condition include the following:</p> <ul style="list-style-type: none"> <li>• Fair value is significantly below cost.</li> <li>• The decline in fair value is attributable to specific adverse conditions affecting a particular investment.</li> <li>• The decline in fair value is attributable to specific conditions, such as conditions in an industry or in a geographic area.</li> <li>• Management does not possess both the intent and the ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value.</li> <li>• The decline in fair value has existed for an extended period of time.</li> <li>• A debt security has been downgraded by a rating agency.</li> <li>• The financial condition of the issuer has deteriorated.</li> <li>• Dividends have been reduced or eliminated, or scheduled interest payments on debt securities have not been made.</li> </ul>				

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
B E	20. Evaluate management's conclusions regarding whether a decline in fair value below the amortized cost basis of investments is other than temporary.	_____	_____	_____

### 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]	21. Determine that sales and purchases were properly approved; trace transactions to minutes of the board of directors or finance committee meetings.	_____	_____	_____
A C E	22. Examine bank or broker's advices and custodian's reports in support of purchases and sales.	_____	_____	_____
C E	23. Determine that gain or loss on disposition of a security has been computed and accounted for properly.	_____	_____	_____
A C E	24. Trace payments for purchases to canceled checks and proceeds from sales to entries in cash book.	_____	_____	_____
	25. 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	26. Determine that the amortization of premium and discount on debt securities, where applicable, has been properly computed and accounted for.	_____	_____	_____
E	27. Determine that any transfers between categories of investments have been properly recorded.	_____	_____	_____
	28. 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.	_____	_____	_____
E	d. For disclosure purposes obtain and evaluate information concerning significant individual or group concentrations of credit risk.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
B E	e. If FASB Statement No. 133, <i>Accounting for Derivative Instruments and Hedging Activities</i> (AC D50), has been adopted, determine whether financial instruments or other contracts that meet the definition of "derivative instruments," as defined in paragraph 6 of FASB Statement No. 133, have been properly accounted for under the requirements of FASB Statement No. 133.	_____	_____	_____
B E	f. If FASB Statement No. 133 (AC D50) has not been adopted, determine whether financial instruments, derivatives, and other contracts have been accounted for in accordance with the related accounting guidance (e.g., futures contracts are accounted for in accordance with FASB Statement No. 80 [AC F80]).	_____	_____	_____
D	29. Determine if any securities are pledged or restricted.	_____	_____	_____
A	30. Evaluate the credit quality of the investments and determine whether purchases and sales conform to policy.	_____	_____	_____
E	31. Ensure that all information needed for financial statement disclosures has been accumulated and documented in the working papers.	_____	_____	_____
E	32. Obtain information about the fair value of investments, and perform the following:			
<p><b>Note:</b> 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, as amended). Also, FASB Statement No. 107 does not apply to investments accounted for under the equity method.</p>				
	a. Determine that the fair value amounts are determined in accordance with FASB Statement No. 107, as amended (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.	_____	_____	_____
	33. Determine that all disclosures, as required by FASB Statement No. 107, as amended (AC F25), are properly made.	_____	_____	_____
<b>D. Accounting by a Transferor and Transferee for All Transfers of Financial Assets</b>				
	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:			

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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 <i>transferor</i> 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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
5. If the client is the <i>transferee</i> , determine that upon the completion of a transfer of assets that satisfies the conditions to be accounted for as a sale, the <i>transferee</i> 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)**

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**F. Section Completion**

- 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.
- 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 \_\_\_\_\_

## Appendix to Illustrative Audit Program for Investments and Derivatives

### Guidance on Auditing Management's Ability and Intent

The following nonauthoritative guidance is extracted from the AICPA's practice aid entitled, *Auditing Estimates and Other Soft Accounting Information*. Practitioners who wish to purchase the full practice aid can order a copy for \$45.00 by calling the AICPA at (888) 777-7077 and asking for product number 010010.

#### *Distinguish Between a Plan and What Management Might Do*

Management's plans are different from management's options. Be sure that the assumptions underlying soft accounting information are based on management's positive intent to take action. The accounting for debt securities depends, in part, on whether management intends to hold those securities to maturity. Paragraph 59 of Statement No. 115 states:

An enterprise should determine if it has the positive intent and ability to hold a security to maturity, which is distinct from the mere absence of an intent to sell. The Board believes that, if management's intention to hold a debt security to maturity is uncertain, it is not appropriate to carry that investment at amortized cost.

Logic can be applied to other areas for the purpose of assessing management's intent. Positive intent to take action is not the same as the absence of intent to take a contrary action.

#### *Inquiries of Management*

A primary source of audit evidence relating to management's intent and ability will come from inquiries of management. As audit evidence, inquiries may be less reliable than other sources of evidence (for example, your direct personal knowledge or confirmations from third parties). The following techniques can help make your inquiries more reliable.

- *Corroborate management's response with additional inquiries outside of management.* You should extend your inquiries to include people outside of management and outside of the accounting department. You might even make inquiries of people outside the entity.
- *Have a rigorous, purposeful approach for making inquiries.* Maintain a healthy professional skepticism when evaluating management's responses. Look for inconsistencies in their responses or between their responses and those of others outside the department. Look for discrepancies between what they say and what they do. Be sure to follow up on all identified inconsistencies.

#### *Written Plans and Other Documentation*

Keep in mind that the mere existence of written documentation is not sufficient for you to reach a conclusion about the reasonableness of management's plans. Like any other audit evidence, documentation received from management must be valid and relevant. Guidance on assessing the validity and relevance of audit evidence is contained in SAS No. 31, *Evidential Matter*, as amended by SAS No. 80 (AICPA, *Professional Standards*, vol. 1, AU sec. 326.21), paragraph 21.

The absence of written documentation and even written documentation that contradicts management's stated plans does not necessarily mean that management's intentions are unsupported.

#### *Assess Management's Ability to Carry Out Their Intentions and Plan*

Be alert for audit evidence that contradicts management's stated intentions. What are the risks the company will encounter in carrying out their intentions, and what are management's plans for identifying and mitigating those risks?

### Guidance on Auditing Fair Value

The best sources of audit evidence for corroborating the fair value of investments are market quotations from published sources. For some investments, market quotations may be obtained from broker-dealers who are market makers in those investments. If market quotations are not available (for example, on securities that do not trade regularly) fair value frequently can be obtained from third-party sources based on proprietary models or from the client based on internally developed or acquired models.

- *Third-party estimates.* Many broker-dealers and other third parties have developed models to estimate the fair value of investments. When obtaining estimates from third parties, be alert for situations where the third party has a relationship with your client that might impair its objectivity. When the third party derives the fair value of a security by using modeling or similar techniques, the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), usually is applicable. The guidance in SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), may also be appropriate if the pricing service extracts market quotes from other sources and prices the investments based on that information.
- *Client modeling.* When the client uses their own valuation model to estimate fair value, treat it like any other determination of soft accounting information. Assess the reasonableness of the model and the support for the assumptions. Consider involving a specialist if you think you don't possess the necessary expertise. Investments in debt securities are often collateralized by real estate, negotiable securities, or other property. If collateral is an important factor in evaluating fair value and collectibility of an investment, you should obtain evidence regarding the existence, transferability, and fair value of that collateral.

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/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)

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**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.

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**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

\_\_\_\_\_

[The next page is 5445.]



<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>[A] B. Substantive Analytical Procedures</b>			
<b>[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.</b>			
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.	_____	_____	_____
<b>C. Detailed Tests</b>			
<b>[A] 1. Review activity in the general ledger control accounts for trade accounts receivable for the period being audited and:</b>			
a. Note and investigate any significant entries which appear unusual in amount or source.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	b. Compare the opening balance for the period with the final closing balances per the working papers and reports for the preceding period.	_____	_____	_____
[A]	2. Obtain or prepare an aged trial balance of trade receivables as of the date selected for confirmation procedures. (Note: In some situations, it may not be practicable to obtain an aged trial balance until after the mailing of confirmation requests, 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.	_____	_____	_____
	<b>Note:</b> 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:			
	_____			
	_____			
	_____			
	_____			
	_____	_____	_____	_____
	<b>Note:</b> 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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<b>Note:</b> 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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, <i>Disclosures about Fair Value of Financial Instruments</i> (AC F25), obtain information about the fair value of notes payable and long-term debt, and perform the following:			
	<u>Note:</u> 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 |
|---|--|

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<hr/>			
<i>Note:</i> See FASB Statement No. 114, <i>Accounting by Creditors for Impairment of a Loan</i> , and FASB Statement No. 118, <i>Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures</i> (AC 108), for further guidance.			
<hr/>			

#### 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)

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\_\_\_\_\_

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 \_\_\_\_\_



The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/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)

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**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.

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>Procedures:</b>			
<b>A. Preliminary Procedures</b>			
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>A B B. Substantive Analytical Procedures</b>			
<b>D</b>			
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.	_____	_____	_____
<b>C. Detailed Tests—General</b>			
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-			

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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-			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
	<b>Note:</b> 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			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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: <ul style="list-style-type: none"> <li>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.</li> <li>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.</li> <li>c. Trace material costs charged to the selected departments to appropriate journals and on a test basis to individual requisitions.</li> <li>d. Trace labor costs incurred to account distribution analyses of the payroll registers.</li> <li>e. Review the allocation of overhead.</li> </ul>	_____	_____	_____
	<b>E. Observation of the Physical Inventory</b>			
	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."	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<b>F. Summarization—Physical Quantities</b>				
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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: _____ _____ _____	_____	_____	_____
CD	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.	_____	_____	_____
CD	4. Perform price tests for all individually significant items of raw materials and purchased finished goods that were included in test counts.	_____	_____	_____
CD	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: _____ _____ _____	_____	_____	_____



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C D	6. Trace unit costs of work-in-process and finished goods to the cost accounting records and perform the following:			
	<p><b>Note:</b> 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.</p>			
	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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?)	_____	_____	_____
	<b>H. Lower of Cost or Market Considerations</b>			
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-			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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 <i>a.</i> and <i>b.</i> 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.	_____	_____	_____
<b>I. Other</b>				
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
D	4. Determine that any intercompany or interdepartmental profit in inventory is eliminated in consolidation.	_____	_____	_____

**J. Additional Procedures (if any)**

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**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 \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/P  
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## 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)

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<p><b>Note:</b> 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.</p>				
<b>Procedures:</b>				
<b>A. Preliminary Procedures</b>				
	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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>B. Substantive Analytical Procedures</b>				
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).	_____	_____	_____
<b>C. Detailed Tests</b>				
	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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 cross-footings of the schedules.	_____	_____	_____
A B [C] F	7. Perform the following tests of selected additions:			
	a. Determine the addition has been authorized by reference to such sources as minutes of the meetings of the Board of Directors or Finance Committee and/or capital asset budgets reviewed by the Board of Directors or Finance Committee or by evidence of approval by appropriate, responsible personnel, in accordance with prescribed policies.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 <i>b</i> 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.	_____	_____	_____
DEGH	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.	_____	_____	_____
EH	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.	_____	_____	_____
ADEGH	18. In accordance with FASB Statement No. 121 (ACI08), if any events or changes in circumstances have occurred indicating that the carrying amount of a long-lived asset may not be recoverable:			
H	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
<b>D. Leases</b>				
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.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
	(2) Test the clerical accuracy of the analyses.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
(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)

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>F. Section Completion</b>			
1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for property, plant, and equipment, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for property, plant, and equipment.	_____	_____	_____
2. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
Done by _____	_____	_____	_____
Reviewed by _____	_____	_____	_____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/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)

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**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.

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<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>Procedures:</b>				
<b>A. Preliminary Procedures</b>				
	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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>B. Substantive Analytical Procedures</b>				
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.	_____	_____	_____
<b>C. Detailed Tests</b>				
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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)**


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**E. Section Completion**

- 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.

\_\_\_\_\_

- The objectives of this audit program have been met.

\_\_\_\_\_

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

Done by \_\_\_\_\_

\_\_\_\_\_

Reviewed by \_\_\_\_\_

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The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.

<u>Done</u> <u>By</u>	<u>Date</u>	<u>W/P</u> <u>Ref.</u>
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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

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	2. Based on the risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
	<b>B. Substantive Analytical Procedures</b>			
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.	_____	_____	_____
	<b>C. Detailed Tests</b>			
	1. Were the following items considered:			
	a. Whether to request positive confirmation from vendors and, if so, when and to what extent.	_____	_____	_____
	<hr/> <i>Note:</i> 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. <hr/>			
	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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)**


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**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.

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2. The objectives of this audit program have been met.

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

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Done by

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Reviewed by

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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**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)

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*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.

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**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 \_\_\_\_\_

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	2. Based on the risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>B. Substantive Analytical Procedures</b>				
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.	_____	_____	_____
<b>C. Detailed Tests</b>				
[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.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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:			

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
a. Test the accounting estimate recorded by management. (See step 10 above.)	_____	_____	_____
<b>Practice Tip</b>			
Read AICPA Statement of Position 96-1, <i>Environmental Remediation Liabilities</i> (appendix C), for guidance in applying step 10 above to environmental remediation liabilities. When auditing environmental remediation liabilities, steps 10a and 10b 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.)	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
[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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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)

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#### 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  
ByDateW/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)

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**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.

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**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

\_\_\_\_\_

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>B. Detailed Tests</b>			
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____

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**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 carryforwards are available.

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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.	_____	_____	_____

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**Practice Tip**

See FASB Statement No. 109, paragraphs 17–26 (AC I27.116–.125), for guidance on valuation allowance computation.

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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.	_____	_____	_____



*Obj.*

*Done  
By*

Date \_\_\_\_\_

**W/P**  
**Ref.**

**C. Additional Procedures (if any)**

[illegible]

### 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

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.130

Obj.Done  
ByDateW/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)

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**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.

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**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

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>A B B. Substantive Analytical Procedures</b>			
<b>C</b>			
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.	_____	_____	_____
<b>C. Detailed Tests</b>			
<b>[A] [B]</b>			
<b>[C] [D]</b>			
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)	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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, <i>Disclosures about Fair Value of Financial Instruments</i> , as amended (AC F25), obtain information about the fair value of notes payable and long-term debt, and perform the following:			
	<p><b>Note:</b> 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.</p>			
	a. Determine that the fair value amounts are determined in accordance with FASB Statement No. 107, as amended (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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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)**

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**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 \_\_\_\_\_

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  
ByDateW/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)

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**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.

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**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

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>B. Substantive Analytical Procedures</b>			
1. Compare balances in shareholders' equity accounts with the preceding year's balances or expected balances. Investigate any significant deviations from the expected amounts.	_____	_____	_____
<b>C. Capital Stock and Additional Paid-In Capital—Detailed Tests</b>			
[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 or prepare and test analyses of stock options which include the following information:			



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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, <i>Accounting for Stock-Based Compensation</i> (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, <i>Accounting for Stock Issued to Employees</i> (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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
<b>D. Retained Earnings—Detailed Tests</b>				
[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.	_____	_____	_____
<b>E. Other</b>				
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.	_____	_____	_____

Obj.Done  
ByDateW/P  
Ref.**F. Additional Procedures (if any)**


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**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.

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2. The objectives of this audit program have been met.

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

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Done by

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Reviewed by

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The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/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)

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**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.

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>Procedures:</b>			
<b>A. Preliminary Procedures</b>			
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>B. Substantive Analytical Procedures</b>			
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.	_____	_____	_____
<b>C. Detailed Tests</b>			
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).	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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, <i>Earnings per Share</i> .	_____	_____	_____

**D. Additional Procedures (if any)**

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**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

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
for revenues and other income, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for revenues and other income.	_____	_____	_____
2. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
_____	_____	_____	_____
Done by			
_____	_____	_____	_____
Reviewed by			



The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/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)

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**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.

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**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

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>A B C B. Substantive Analytical Procedures</b>			
<b>D E F</b>			
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.

- 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.

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<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
<b>C. Detailed Tests</b>				
	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, <i>Reporting on Advertising Costs</i> .	_____	_____	_____
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	6. Consider whether the classification of expenses is in conformity with generally accepted accounting principles consistently applied.	_____	_____	_____
<b>D. Payroll</b>				
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)**

_____
_____
_____
_____
_____
_____
_____
_____

Obj.Done  
ByDateW/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.

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

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 Done by

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 Reviewed by

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The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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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. (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. Assessment of risk of material misstatement (due to error, fraud, illegal acts, or other factors)
  - c. Other planning documents and risk assessments

_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	2. Based on the risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
	<b>B. Contingencies</b>			
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 working papers.	_____	_____	_____
A B	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<u>List of All Lawyer Letters Requested</u>		<u>Date Requested</u>	<u>Received</u>	
_____		_____	_____	
_____		_____	_____	
_____		_____	_____	
_____		_____	_____	
_____		_____	_____	
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 <i>may</i> 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.)



<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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)

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#### E. Section Completion

- 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.

\_\_\_\_\_

- 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  
ByDateW/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)

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**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.

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**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-

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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>B. Section Completion</b>				
	1. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.				
Done by _____		_____	_____	_____
Reviewed by _____		_____	_____	_____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/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)

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**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.

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**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 risk assessment made during planning (including the risk of material misstatement due to error or fraud), determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning docu-

_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	ments (e.g., Fraud Risk Factor Memory Jogger [AAM section 3165.12]) when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<b>B. Substantive Test Procedures</b>				
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)**

_____
_____
_____
_____
_____
_____
_____
_____
_____
_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>D. Section Completion</b>			
1. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
_____	_____	_____	_____
Done by	_____	_____	_____
_____	_____	_____	_____
Reviewed by	_____	_____	_____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.200  
Obj.

Done      W/P  
By      Date      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	_____	_____	_____



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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>B. Section Completion</b>				
	1. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.				
Done by _____		_____	_____	_____
Reviewed by _____		_____	_____	_____

[The next page is 5551.]



# AAM Section 5410

## *Suggested Supplemental Reference Materials for Use With Illustrative Audit Program for Corporations*

### .01 Suggested Supplemental Reference Materials

The following publications are useful in helping to determine the nature, timing, and extent of audit procedures. To order AICPA products, call 1-888-777-7077.

- **Audit and Accounting Guides (AICPA)**

*Each guide describes relevant matters, conditions, and procedures unique to a particular industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.*

- **Audit Risk Alerts (AICPA)**

*Audit Risk Alerts complement the guidance provided in many of the Audit and Accounting Guides by describing current economic, regulatory, and professional developments that can have a significant impact on engagements.*

- **Professional Standards (AICPA)**

*The publication features the outstanding pronouncements on professional standards issued by the AICPA, including standards for audits, compilations, and reviews.*

- **Accounting Standards—Original Pronouncements (FASB)**

*This publication contains the original text of accounting standards pronouncements with superseded sections and amendments clearly noted.*

- **Accounting Standards—Current Text (FASB)**

*This publication is organized as follows: General Standards—generally applicable to all enterprises; Industry Standards—applicable to enterprises operating in specific industries. It includes comprehensive summaries of each subject, plus applicable standards, illustrations and examples.*

- **Financial Statement Preparation Manual (AICPA)**

*This publication provides sample statements and checklists for a variety of business enterprises and governmental units.*

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

*The practice aids are invaluable to anyone who prepares financial statements and reports. The material has been updated to reflect AICPA, FASB, and GASB pronouncements and interpretations as well as SEC regulations.*

- **Considering Fraud in a Financial Statement Audit (AICPA)**

*This practice guide provides nonauthoritative guidance in implementing Statement on Auditing Standards (SAS) No. 82, Consideration of Fraud in a Financial Statement Audit. The purpose of this book is to help you make informed professional judgments when you consider fraud in a financial statement audit.*

- **Auditing Estimates and Other Soft Accounting Information (AICPA)**

*This practice guide provides nonauthoritative guidance for handling the audit problems related to the audit of soft accounting information, including how SAS No. 57, Auditing Accounting Estimates, may be applied by practicing auditors.*

- **Accounting Trends & Techniques (AICPA)**

*This publication contains reporting methods, based on a cumulative survey; significant accounting presentations, discussions and trends. By following the lead of these industry front-runners, you can apply the latest techniques and improve your own reporting performance.*

- **Technical Practice Aids (AICPA)**

*This publication contains all outstanding AICPA Statements of Position and Practice Bulletins and offers carefully thought-out responses to selected inquiries received by the AICPA Technical Hotline and AICPA Technical and Industry Committees.*

- **Auditing Practice Releases (AICPA)**

*These publications are intended to provide practitioners with non-authoritative practical assistance concerning auditing procedures. Topics include: Confirmation of accounts receivable and audits of inventories.*

- **Solving the Year 2000 Dilemma (AICPA)**

*This guidebook features case studies and gives timely, quality information on the problem in easily understood language.*

- **Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools (AICPA)**

*By focusing on unique reporting and auditing matters of commodity entities, this publication gives you nonauthoritative practical guidance on reporting on and auditing these financial statements.*

- **Audit Issues in Revenue Recognition (AICPA)**

*This publication enables preparers, auditors, and audit committees to better understand the importance of accurate revenue recognition. It also reinforces best practices and summarizes the applicable accounting and auditing standards.*

- **Standard Confirmation Forms (AICPA)**

*This form may be used to request a full report on credit balance, liabilities and contingent liabilities. It may also be used for a confirmation of bank balance only.*

- **EITF Abstracts—A Summary of Proceedings of the FASB Emerging Issues Task Force**

- **Accountants' Handbook by Carmichael, Lilien & Mellman (Wiley)**

- **Montgomery's Auditing by O'Reilly, Hirsch, Defliese, and Jaenicke (Wiley)**

- **Handbook of Modern Accounting by Davidson & Weil (McGraw-Hill)**

- **Kohler's Dictionary for Accountants by Coopers & Ijiri (Prentice-Hall)**

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# AAM Section 6000

## Working Papers

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# AAM Section 6100

## *Working Papers—General*

.01 Working papers serve both as tools to aid the auditor in performing his work, and as written evidence of the work done to support the auditor's report. SAS No. 41, *Working Papers* (AU section 339), provides authoritative guidance on the functions and nature, general content, and ownership and custody of working papers.

### General Discussion

.02 These sections present points of view on the organization and preparation of working papers.

.03 Proper planning is important in the design of specific working papers if they are to serve the objective of aiding the auditor in the conduct of his work. For example, a well-planned working paper may be designed to provide information that will be needed later in the preparation of tax returns and other required reports, such as those to regulatory bodies, and may therefore eliminate the need for examining the same documents twice to obtain necessary information. The format and content of the working papers may vary with the individual preferences of auditors and firms. These preferences may be informal common practices or expressed as part of a firm's formal written policies and procedures. A firm should consider the nature of its practice and the services commonly provided to its clients, as well as professional standards in developing its procedures and policies on working papers. Those procedures and policies should permit the flexibility necessary to meet the needs of individual engagements.

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[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.

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[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-

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.

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*[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—

	<i>Two Possible Alternatives</i>	
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:

	<i>Using Letters and Numbers</i>	<i>Using Only Numbers</i>
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) (A-2-1) (A-2-2) (A-2-3)	(10-1-1) (10-1-2) (10-2-1) (10-2-2)

.05 Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of working paper binders or files when the work is completed. Some firms have their uniform indexing systems printed directly on their file or binder covers.

.06 A well-organized indexing system need not be too complex. On a fairly small engagement, the indexing system may be a lead schedule divider tab between each major group of accounts with the name of the account on it (e.g., cash or accounts receivable) with the related workpapers filed behind the lead schedule without being individually indexed. At the completion of the engagement, the pages can be consecutively numbered within each account group (e.g., 1 of 10, 2 of 10, etc.), since there typically are not numerous or complex layers of supporting schedules, extensive cross-referencing can be avoided.

.07 On large engagements, particularly those with detailed charts of accounts, firms may consider it necessary to develop more complex indexing systems. In one such system, standard index number series are assigned as follows:

Current workpaper file . . . . .	1000—7000
Permanent file . . . . .	7100—9999

.08 In this system, each index number consists of four digits, with the addition decimals if necessary. Numbers ending with double zero are reserved for lead schedules whose total agrees with a line item on the working trial balance (index 1400). Single zeros are used for specific types of accounts (such as 2010, petty cash funds).

.09 Certain index numbers can be permanently assigned to each major financial statement classification. For instance, index 2000 may be assigned to cash. If various bank accounts exist, the cash schedules are assigned index numbers 2002, 2003, etc. Documentation such as supporting confirmations and lists of outstanding checks would be assigned index numbers commencing with 2001.1, 2001.2, etc. As for the permanent workpaper file, index 9300, for example, may be assigned to internal control. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

**Current and Permanent Files**

.10 Working paper files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform working paper indexes.

.11 A common challenge to many auditors is to keep the permanent file complete and current, and free from outdated or irrelevant materials that belong in an inactive file of superseded materials.

.12 Some auditors who have confronted one too many unwieldy permanent files believe all working papers should be classified as current with certain materials designated as *matters of continuing interest* to



be carried forward each year until they become outdated. Under this approach, a firm may preprint its complete index on one type of file or binder cover and provide space to indicate whether specific contents are continuing or carryforward in nature.

.13 The permanent files should be reviewed and updated, as needed, annually. Examples of documents that may be found in permanent files are listed in AAM section 6400.15(p).

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#### 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.

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## Work-Paper Retention

.14 Determining the proper periods for retaining records is a major decision for practitioners. Records should be preserved for only as long as they serve a useful purpose or until all legal requirements are met. Record retention periods vary among firms; however, retention periods should generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

.15 Work-papers may be retained permanently or for periods corresponding with the longest state statute of limitations, as noted above. Generally, certain audited financial statement work-paper data, such as accounts receivable confirmations are destroyed after ten years. Examples of workpapers that should be retained permanently include auditor's reports, reports filed with the SEC, tax returns for current clients, and audit work-papers for current clients. Some firms divide the retention period into two parts, records are first filed in the office and later placed in storage (e.g., three years in the office and then permanently in storage). Other records, such as work-paper files for former clients, may be retained for three years in the office, seven years in storage and then destroyed after the retention period. No material should be destroyed without the specific approval of the engagement partner. An annual schedule should be established for reviewing and purging firm data. Since there is substantial variation in the retention periods used by firms, each firm should carefully consider its requirements and consult with legal counsel before adopting a retention period.

.16 For further guidance on record retention, see the *AICPA Management of an Accounting Practice Handbook*.

## Index Topics

.17 The following is a list of topics to consider in developing a standard index for working papers. This list is detailed, but is by no means all-inclusive. For example, specialized industries such as life insurance and banking need other specialized topics. Several of the topics may be eliminated, condensed or expanded, depending on the auditor's needs and preferences. Topics that some auditors prefer to include in both the permanent and current files or only in the permanent files are followed by the letter (P).

### Planning and administration

- Time & budget data
- General correspondence & memos
- Planning memos—current
- Planning notes & confirm copies for use in next engagement
- Engagement letters

- Schedules & analyses to be prepared by client
- Minutes
- Checklist of an administrative nature if required by firm policy

Audit or work program (Note 1)

Matters of continuing concern

- Client's industry—background (P)
- Description & brief history of client (P)
- Data & ratio analysis of client's operations (P)
- Client's facilities (P)
- Articles of incorporation (P)
- Bylaws (P)
- Current contracts & agreements (P)
  - Debt agreements (P)
  - Leases (P)
  - Labor contracts (P)
  - Agreements with officers & key people (P)
  - Pension plans (P)
  - Profit-sharing plans (P)
  - Stock warrants (P)
  - Stock options (P)
  - Other agreements (P)

- Client's accounting policies & procedures (P)
- Carryforward analyses (Note 2)

Internal control

- Internal control questionnaire, narratives, flowcharts, etc. (Note 3)
- Initial assessment of control risk memos
- Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets

- Reports & financial statements (including letter, if any, on reportable conditions in internal control)
- Consolidating working papers
- Consolidation eliminating entries
- Trial balance

- Adjusting journal entries
- Reclassification journal entries
- Recap of possible adjusting entries
- Assembly sheets supporting footnote disclosures (if the information is not included elsewhere in the working papers)
- Disclosure checklists (if required by firm policy)
- Supporting schedules (if required for reports to regulatory bodies or other reports)
- Tax return information & work sheets (Note 4)

#### Assets

- Cash
- Marketable securities (and related income)
- Notes receivable (and related interest)
- Accounts receivable
  - Summary and analyses
  - Confirmation procedures (Notes 2 and 5)
- Allowance for doubtful accounts & notes (Note 2)
- Inventories
  - Summary and analyses
  - Price tests, cost & market
  - Obsolescence review
  - Observation, test counts & cutoff data
  - LIFO determinations
- Prepaid expenses
- Other current assets
- Investments
- Property, plant & equipment, and accumulated depreciation, depletion & amortization (Note 2)
- Intangible assets, deferred charges & amortization (Note 2)
- Other assets
- Intercompany accounts

#### Liabilities

- Notes payable (and related interest)
- Accounts payable
- Accrued liabilities other than income taxes

- Accrued income taxes (current & deferred), related provisions & credits (Note 2)
  - Federal
  - State & local
- Other current liabilities
- Long-term debt (including current maturities and capitalized leases) (Note 2)
- Other long-term liabilities
- Deferred income (Note 2)

Commitments and contingencies

- Attorneys' letters
- Abstracts of commitments & contingencies noted during review of minutes, contracts & agreements, confirmation responses, etc.
- Subsequent events review
- Management representation letter

Equity (capital accounts) (Note 2)

- Capital stock
- Additional paid-in capital
- Treasury stock
- Retained earnings
- Partnership capital

Revenue and expenses

- Operating revenues
- Cost of sales
- Selling, general & administrative
- Other operating expenses
- Other income
- Other expense
- Extraordinary & unusual items
- Secondary schedules
  - Maintenance & repairs
  - Taxes other than income taxes
  - Rents
  - Royalties
  - Advertising costs
  - Legal fees
  - Interest expense recap

---

**Notes to User:**

1. Alternate practices of filing audit programs include:
    - (a) Putting the program in a binder that is separate and distinct from the current and permanent files.
    - (b) Putting the signed off program in the current file.
    - (c) Keeping a master copy of the program in the permanent file with the signed off copies dispersed among the related working paper segments in the current file.
  2. Certain classifications may lend themselves to carry-forward working papers. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long-term debt, and capital accounts.
  3. Internal control questionnaires may be filed as separate binders or as part of current of permanent files.
  4. Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.
  5. For situations involving voluminous confirmation responses or bulk inventory listings, the bulk materials may be filed in separate binders that are cross referenced to the pertinent working papers (for example: accounts receivable, accounts payable, and inventory).
- 

[The next page is 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.

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[The next page is 7101.]



# AAM Section 7100

## *Control of Confirmations and Correspondence*

.01 Generally, clients prepare correspondence and confirmation requests on their own letterhead and submit to the auditor the signed originals and copies. The auditor may obtain one or more copies to serve as file copies for the current working papers, second requests and manuscript copies for the next engagement.

.02 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.03 The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when: (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

.04 The confirmation requests should be reviewed to the extent the auditor considers necessary. For example, the auditor may perform the following for accounts receivable confirmation requests before they are mailed:

- Compare the names and addresses to the client's records.
- Compare balances per confirmation requests to the subsidiary ledger.

.05 The requests would then be stuffed in envelopes and submitted to the post office under the auditor's control.

.06 The auditor controls the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 Mailing envelopes have the auditor's office or post office box number as the return address so that undeliverable letters are returned to the auditor and not to the client. For mailings, the auditor may provide the envelopes or affix a label on the client's envelope that covers the client's return address and replaces it with the auditor's address.

.08 Reply envelopes addressed to the auditor are enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

.09 If the client objects to use of the auditor's name and address, some auditors suggest that a post office box in the client's name be used, with the returns to be opened under the auditor's control for the confirmation process, and that the post office be instructed that after the box is closed subsequent mail be forwarded to the auditor.

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[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.

<i>Account Number</i>	<i>Account Name</i>
_____	_____
_____	_____
_____	_____
_____	_____

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.)

.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.

[ ]

**.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):

---

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Date: \_\_\_\_\_ Signed: \_\_\_\_\_

**.06 Securities and Cash in Custodian or Trust Accounts***[Prepared on Client's Letterhead]**[Date]**[Name of Custodian or Trustee]**[Address]*

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



**.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]*

**.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: \_\_\_\_\_

**.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]

.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:

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).

[ ]  
REPORT FROM  
INSURANCE  
COMPANY

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 (✓).

<input type="checkbox"/> 10 Is There an Assignee of Record? (Enter Yes or No)			
<input type="checkbox"/> 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)	*	*	*
<input type="checkbox"/> 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: <input type="checkbox"/> Yes <input type="checkbox"/> 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:

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,

REPORT [ ]  
FROM  
INSURANCE  
COMPANY

(Name of owner as shown on policy contract)

By \_\_\_\_\_  
Authorized Signature

Information requested as of: \_\_\_\_\_  
(Date)

		Policy #1	Policy #2	Policy #3
Additional forms available from AICPA-ORDER PO BOX 0946 NYC, NY 10108-0946	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 (✓).				
<input type="checkbox"/> 10 Is There an Assignee of Record? (Enter Yes or No)				
<input type="checkbox"/> 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*
<input type="checkbox"/> 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: <input type="checkbox"/> Yes <input type="checkbox"/> 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



**.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:

<u>Participants</u>	<u>Number of Persons</u>	<u>Compensation (if applicable)</u>
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:

<u>Participant's Name or Number</u>	<u>Age or Birth Date</u>	<u>Sex</u>	<u>Salary</u>	<u>Date Hired or Years of Service</u>
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*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.

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 \_\_\_\_\_:

1. Pension Benefit Obligation *Estimated*

- 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:  
( $1c - 2$ )

4. Unrecognized Prior Service Cost

5. Unrecognized Net Loss or (Gain)

6. Unrecognized Net Transition Liability or (Asset)

7. Additional Liability

8. Accrued or (prepaid) pension cost in the company financial statements  
( $3 - 4 - 5 - 6 + 7$ )

\$ \_\_\_\_\_

9. The above amount of the projected benefit obligation is 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 settlements, curtailments or termination benefits during the year, such as:
1. Purchases of annuity contracts,
  2. Lump-sum cash payments to plan participants,
  3. Other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation, and eliminates significant risks related to the obligation and assets,
  4. Any events that significantly reduced the expected years of future service of employees,
  5. Any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or
  6. Any special or contractual termination benefits offered to employees.
- F. Was all of the information above determined in accordance with FASB Statements No. 87 and No. 88 (including the FASB's Guides to Implementation of Statements 87 and 88 and the American Academy of Actuaries', "An Actuary's Guide to Compliance with Statement of Financial Accounting Standards No. 87") to the best of your knowledge? If not, please describe any differences.
- G. Describe the nature of your relationship, if any, with the plan or the plan sponsor that may impair or appear to impair the objectivity of your work.

Very truly yours,

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[Client's Authorized Signature]

**.16 Pension Plan Assets Held by Trustee**

[Prepared on Client's Letterhead]

[Date]

[Name of Trustee or Custodian]

[Address]

Our auditors (*name and address of auditor*) are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of (*date*) for our employees' pension trust (*title and trustee's account number*).

Please also provide the auditors with the following information about our employees' pension trust for the period from (*beginning of period*) to (*end of period*) [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]

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**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.

<u>Participant's Name or Number</u>	<u>Age or Birth Date</u>	<u>Sex</u>	<u>Salary</u>	<u>Date Hired or Years of Service</u>
---	------------------------------	------------	---------------	---

(Note to auditor—Select sample participants from records and list them here.)

C. Please indicate, with respect to the actuarial present value of credited projected benefits (hereinafter referred to as the APV of CPB or "pension benefit obligation")

1. Date of the most recent actuarial valuation in which the APV of CPB was calculated and the date of any subsequent actuarial update.
2. Significant actuarial assumptions used to compute the APV of CPB, including rate of return on investment of present and future assets, projected salary increases due to (a) inflation and (b) merit or seniority, and postretirement benefit increases.

\* Disclosures are required pursuant to GASB Codification of Governmental Accounting and Financial Reporting Standards, paragraphs Pe6.130–.132, P20.123–.127, and .131, as of June 15, 1987.

3. Amount of the entire APV of CPB, for the entire PERS, in total and segregated as follows:
    - a. Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them.
    - b. Current employees:
      - (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

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\*\* 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.

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”” 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.



- 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.

<u>Participant's Name or Number</u>	<u>Age or Birth Date</u>	<u>Sex</u>	<u>Salary</u>	<u>Date Hired or Years of Service</u>
---	------------------------------	------------	---------------	---

(*Note to auditor*—Select sample participants from records and list them here.)

- C. Actuarially determined contribution requirement applicable to (*name of governmental employer*) participants, expressed both in a dollar amount and as a percentage of current-year covered payroll. Also, describe any current-year changes in actuarial assumptions, benefit provisions, actuarial funding method, or other significant factors, and the aggregate effect on the actuarially determined contribution requirement applicable to (*name of governmental employer*) participants, expressed as a percentage of current-year covered payroll.
- D. The total PERS actuarial present value of credited projected benefits (APV of CPB).
- E. Market value of the total PERS net assets available for benefits (as of the same date as the APV of CPB).
- F. Amortized cost value of the total PERS net assets available for benefits (as of the same date as the APV of CPB)."

\* Disclosures are required pursuant to GASB Codification of Governmental Accounting and Financial Reporting Standards, paragraph P20.127, as of June 15, 1987.

" Information on amortized cost values need be obtained only if the plan is accounted for in accordance with the requirements of National Council on Governmental Accounting Statements Nos. 1, *Governmental Accounting and Financial Reporting Principles*, or 6, *Pension Accounting and Financial Reporting: Public Employee Retirement Systems, and State and Local Government Employers*, as permitted by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*, paragraph 4.

- G. The actuarially determined contribution requirement applicable to *(name of governmental employer)* participants, expressed as a percentage of the total current-year actuarially determined contribution requirement for the PERS as a whole.
- H. Please indicate that the information you provide has been determined in accordance with the provisions of GASB Statement No. 5, or explain any exceptions.
- I. Please describe the nature of any relationship you have with the *(name of PERS)* or *(name of contributing governmental employer or nonemployer contributor)* that may impair, or appear to impair, the independence and objectivity of your work.
- J. Please provide information relating to subsequent events that could affect the information provided herein.
- K. Please advise if notification has been received of a decision to partially or fully terminate the plan and explain the effect of the decision.
- L. Please provide any additional information you consider necessary.

Very truly yours,

*[Name of Contributing Governmental  
Employer or Nonemployer Contributor]*

By *[Name and Title of Requesting Official  
of Contributing Governmental Employer  
or Nonemployer Contributor]*

**.19 Notes Payable**

[Prepared on Client's Letterhead]

[Date]

[Name]

[Address]

Our auditors (*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: \_\_\_\_\_

**.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 ( <i>dates from and to</i> ) 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]*

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**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]*

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Our records indicate that a balance of \$\_\_\_\_\_ was from (*name of client*) at (*date*).

Date: \_\_\_\_\_

Signature: \_\_\_\_\_

Title: \_\_\_\_\_

**.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]*

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**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.



**.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: \_\_\_\_\_

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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: \_\_\_\_\_

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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.

**.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]*

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<i>Account No.</i>	<i>Date</i>	<i>Balance</i>

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.

<u>Name of Maker</u>	<u>Date of Note</u>	<u>Due Date</u>	<u>Current Balance</u>
	<u>Date Through Which Interest is Paid</u>	<u>Description of Collateral</u>	<u>Description of Purpose of Note</u>

Information related to oral and written guarantees is as follows:

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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]

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By: \_\_\_\_\_

[Authorized Signature]

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

Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution.\* Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. [Note exceptions below or in an attached letter.]

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\_\_\_\_\_  
[Name of Financial Institution]

By:

\_\_\_\_\_  
[Officer]

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

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

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\* 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:

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**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.

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In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of \_\_\_\_ *(business)* *(calendar)* days.<sup>1</sup>

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.<sup>2</sup>

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

<sup>1</sup> 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.

<sup>2</sup> Applicable only if the financial institution has applied sanctions during the *(period)* or notified the Company that sanctions may be applied. Indicate details.

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:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

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\* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the lines of credit. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.



Please confirm whether the information about lines of credit presented above is correct by signing below and returning this letter directly to our independent auditors (*name and address of CPA Firm*).

Sincerely,

[*Name of 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,

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[Client's Authorized Signature]

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[Title]

[Client Name]

**Related-Party Questionnaire**

1. Have you or any related-party of yours had any material interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements or guarantees or other transactions since (*beginning of period of audit*) to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?
2. Do you or any related-party of yours have any material interest, direct or indirect, in any pending or incomplete sales, purchases, transfers, leasing arrangements, guarantees or other transactions to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?
3. Have you or any related-party of yours been indebted to the Company (or specify any pension, retirement, savings, or similar plan provided by the client) at any time since (*beginning of period of audit*)? Please exclude amounts due for purchases on usual trade terms and for ordinary travel and expense advances.

The answers to the foregoing questions are correctly stated to the best of my knowledge and belief.

\_\_\_\_\_  
[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]

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Our auditors, \_\_\_\_\_ [name and address of auditors], are conducting an audit of our financial statements. Accordingly, please confirm there has been no access to our safe deposit box number \_\_\_\_ between \_\_\_\_ and \_\_\_\_ o'clock.

Please indicate in the space below if the above is in agreement with your records. If it is not, please furnish the auditors any details concerning access to our safe deposit box during the period indicated.

After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Very truly yours,

---

[Client's Authorized Signature]

According to our records, there has been no access to the above described safe deposit box during the period specified, except as follows: \_\_\_\_\_

Signed: \_\_\_\_\_ Date: \_\_\_\_\_  
[Name and Title]

**.32 Insurance In Force Confirmation Request**

[Date]

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Our auditors, \_\_\_\_\_ [name and address of auditors], are conducting an audit of our financial statements. In that connection, please confirm the details of our insurance coverage in force at \_\_\_\_\_ [balance-sheet date] as described below:

Policy number	_____	_____
Insurance company	_____	_____
Type of coverage	_____	_____
Amount of coverage	_____	_____
Co-insurance, if any	_____	_____
Term of policy	_____	_____
Gross premium	_____	_____
Amount of unpaid premiums	_____	_____
Loss payees, if other than us	_____	_____
Claims pending at _____ [date]	_____	_____

Please compare this information with your records and inform our auditors, in the space, 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]

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In connection with the audit of our financial statements for the period ending \_\_\_\_\_ [fiscal year end] by our independent auditors \_\_\_\_\_ [name, address], please furnish them a copy of the most recent actuarial valuation report for \_\_\_\_\_ [name of plan]. If a complete actuarial valuation was not prepared as of \_\_\_\_\_ [date], please provide any reports or letters that summarize end-of-period amounts. If the information requested below is included in the valuation report, you may refer to the location in your report rather than repeating such information.

**A. Please provide a brief description of the following:**

1. The participant group(s) (for example, employee, retiree and dependent group[s]) covered, and the types of benefits provided.
2. The provisions of the substantive plan at the beginning of the period used in the calculation of the net periodic postretirement benefit cost for the period.
3. Any changes between the provisions of the substantive plan at the beginning of the period used in the calculation of net periodic postretirement benefit costs and the substantive plan used in the calculation of the accumulated postretirement benefit obligation (APBO) at the disclosure date. Additionally, please specify the following:
  - a. The disclosure date (which cannot be more than three months prior to the end of the period).
  - b. How these changes were included in the net periodic postretirement benefit costs for the period.
4. The date and description of plan amendments adopted during the period and whether the amendment(s) were included in items 2 and 3 above.
5. Any participants, benefits or plan terms excluded from the calculations and the reasons for their exclusion.
6. The funding policy for the plan if other than pay-as-you-go.
7. Any significant liabilities other than for benefits.
8. The method and the amortization period, if any, used for amortizing:
  - a. Any transition asset or obligation.
  - b. Unrecognized prior service cost.
  - c. Unrecognized net gain or loss.
9. If the plan is funded, provide:
  - a. The amounts and types of securities used to value plan assets.
  - b. Calculation of fair value of plan assets.
  - c. The date as of which fair value was calculated.
  - d. The method of determining the value of any contracts with insurance companies and participation provisions included in the plan assets.

10. The following information relating to the participants' demographic and compensation data used in calculating the APBO and net periodic postretirement benefit cost:

- a. The source of the demographic data and the date as of which the data were collected.
- b. The following information concerning the participants and their beneficiaries in the following (or a comparable) format. Please indicate any groups of participants excluded from the information.

<u>Participants</u>	<u>Number of persons</u>	<u>Compensation (if applicable)</u>
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:

<u>Participants' name or number</u>	<u>Age or birth date</u>	<u>Sex</u>	<u>Salary</u>	<u>Date hired or year of initial eligibility</u>
_____	_____	_____	_____	_____

11. A summary of the per-capita claims costs used in the valuation and the basis for their development, including:

- a. In employer-specific claims data were used in connection with the development of per-capita claims cost by age, a description of the data, its source and the period from which it was taken.
- b. If an external data source was used in connection with the development of per-capita claims costs by age, describe the nature of the external data source and how it was used.
- c. The extent to which external data sources were used to adjust the historical claims data.

B. Please provide the following components of the net periodic postretirement benefit cost for the period (see A.2. above):

1. Service cost \$ \_\_\_\_\_
2. Interest cost \_\_\_\_\_
3. Actual return on plan assets \_\_\_\_\_
4. Other components, net:
  - a. Net asset gain (loss) during the period deferred for later recognition \$ \_\_\_\_\_
  - b. Amortization of net loss (gain) from earlier periods \_\_\_\_\_
  - c. Amortization of unrecognized prior service cost \_\_\_\_\_
  - d. Amortization of the transition obligation \_\_\_\_\_
  - e. Net total of other components ( $a + b + c + d$ ) \_\_\_\_\_
5. Net periodic postretirement benefit cost ( $1 + 2 - 3 + 4e$ ) \$ \_\_\_\_\_

C. Please provide the following information related to the APBO as of the disclosure date (see A.3. above):

	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 1a-1f)	_____
2. Fair value of plan assets	_____
3. Funded status (1g-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.



**SPECIFIC ASSUMPTIONS FOR RETIREE HEALTH CARE BENEFITS**

	<u>Net periodic cost</u>	<u>APBO</u>
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,

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[*Client Official*]

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[*The next page is 7301.*]

# AAM Section 7300

## *Inquiries to Legal Counsel<sup>A</sup>*

### .01 Illustrative Inquiry Letter to Legal Counsel<sup>B</sup>

[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]

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**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.

(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.

**.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*]

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**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.

### .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.

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[The next page is 7401.]





# AAM Section 7400

## *Management Representations and Representation Letters*

.01 Statement on Auditing Standards (SAS) No. 85, *Management Representations* (AU section 333), requires an auditor to obtain written representations from management for all financial statements and periods covered by the auditor's report. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements.

.02 Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations. Such representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.

### Specific Representations

.03 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles, specific representations should relate to the following matters:

#### *Financial Statements*

- a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.
- b. Management's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles.

#### *Completeness of Information*

- c. Availability of all financial records and related data.
- d. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.
- e. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
- f. Absence of unrecorded transactions.

#### *Recognition, Measurement, and Disclosure*

- g. Information concerning fraud involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.
- h. Plans or intentions that may affect the carrying value or classification of assets or liabilities.

- i. Information concerning related-party transactions and amounts receivable from or payable to related parties.
- j. Guarantees, whether written or oral, under which the entity is contingently liable.
- k. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.
- l. 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.
- m. Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* (AC C59). (See footnote 7 of SAS No. 85, if the entity has not consulted with a lawyer.)
- n. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
- o. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.
- p. Compliance with aspects of contractual agreements that may affect the financial statements.

#### *Subsequent Events*

- q. Information concerning subsequent events.

The representation letter ordinarily should be tailored to include additional appropriate representations from management concerning matters specific to the entity's business or industry.

## Materiality Considerations

.04 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms. Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements.

## Addressing and Dating

.05 The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of a date no earlier than the date of the auditor's report.

## Management's Signatures

.06 The letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others with equivalent positions in the entity.

## Scope Limitations

.07 Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate. Further, the auditor should consider the effects of the refusal on his or her ability to rely on other management representations.

## Illustrative Representation Letter—Audit of Financial Statements

.08 The following letter, which relates to an audit of financial statements prepared in conformity with generally accepted accounting principles, is presented for illustrative purposes only. The introductory paragraph should specify the financial statements and periods covered by the auditor's report, for example, "balance sheets of XYZ Company as of December 31, 19X1 and 19X0, and the related statements of income and retained earnings and cash flows for the years then ended." The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited.

.09 If matters exist that should be disclosed to the auditor, they should be indicated by listing them following the representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . ." Similarly, in appropriate circumstances, item 6 could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for our plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 19X1, meeting of the board of directors."

.10 The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

.11 Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), and related parties, in SAS No. 45, *Related Parties*, footnote 1 (AU section 334). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to management or request that the definitions be included in the written representations.

.12 The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in paragraph 8 of SAS No. 85.

**.13 Illustrative Representation Letter**

[Prepared on Client's Letterhead]

[Date]

To [Independent Auditor]

We are providing this letter in connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

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

We confirm, to the best of our knowledge and belief, (as of [date of auditor's report],) the following representations made to you during your audit(s):

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all—
  - a. Financial records and related data.
  - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. There has been no—
  - a. Fraud involving management or employees who have significant roles in internal control.
  - b. Fraud involving others that could have a material effect on the financial statements.
6. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
7. The following have been properly recorded or disclosed in the financial statements—
  - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
  - b. Guarantees, whether written or oral, under which the company is contingently liable.
  - c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. (Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.)

8. 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.
  - Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.<sup>1</sup>
  - Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
9. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
10. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

*[Add additional representations that are unique to the entity's business or industry. (See paragraph 7 and appendix B, "Additional Illustrative Representations," of SAS No. 85).]*

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

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*[Name of Chief Executive  
Officer and Title]*

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*[Name of Chief Financial  
Officer and Title]*

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<sup>1</sup> In the circumstances discussed in footnote 7 of SAS No. 85, this representation might be worded as follows:  
We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

**.14 Illustrative Representation Letter—Audit of Personal Financial Statements**

[Date]

[To the Independent Auditor]

We are providing this letter in connection with your audit of the statement of financial condition of James and Jane Person as of [date] and the related statement of changes in net worth for the [period] then ended for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial condition and changes in the net worth, of James and Jane Person in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the statement of financial condition and changes in net worth in conformity with generally accepted accounting principles.

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

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

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all financial records and related data.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. There has been no—
  - a. Fraud involving us, or others who have significant roles in internal control.
  - b. Fraud involving others that could have a material effect on the financial statements.
5. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
6. The following have been properly recorded or disclosed in the financial statements:
  - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
  - b. Guarantees, whether written or oral, under which we are contingently liable.
  - c. Significant estimates and material concentrations known to us that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]
7. There are no—
  - a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

- b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.<sup>1</sup>
  - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
- 8. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
  - 9. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

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

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(James Person)

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(Jane Person)

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<sup>1</sup> Footnote 7 of SAS No. 85, *Management Representations*, states that if a lawyer has not been consulted regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments. In the circumstances discussed in footnote 7 to SAS No. 85, this representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

**.15 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.



**.16 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]

**.17 Illustrative Updating Management Representation Letter**

The following letter is presented for illustrative purposes only. It may be used in the circumstances described in paragraph 12 of SAS No. 85. Management need not repeat all of the representations made in the previous representation letter.

If matters exist that should be disclosed to the auditor, they should be indicated by listing them following the representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ."

[Firm's Letterhead]

[Date]

To [Auditor]

In connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with generally accepted accounting principles, you were previously provided with a representation letter under date of [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

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

\_\_\_\_\_  
[Name of Chief Executive  
Officer and Title]

\_\_\_\_\_  
[Name of Chief Financial  
Officer and Title]

\_\_\_\_\_  
[The next page is 7501.]

# AAM Section 7500

## *Communication With Audit Committees*

### .01 Illustrative Communication With Audit Committees

#### Addressee:<sup>\*</sup>

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,<sup>\*</sup> 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

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<sup>\*</sup> 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) and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 61, as amended by SAS No. 87 (AU section 380)]

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**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.

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\* Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

**.02 Report on Reportable Conditions**

[Date of Auditor's Report on the Financial Statements]

In planning and performing our audit of the financial statements of the \_\_\_\_\_ (client's name) for the year ended \_\_\_\_\_ (financial statement date), we considered its internal control 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 and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

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*[Engagement Partner]*

**.03 Report on Reportable Conditions That Also Identifies a Material Weakness**

[Date of Auditor's Report on the Financial Statements]

In planning and performing our audit of the financial statements of the \_\_\_\_\_ (client's name) for the year ended \_\_\_\_\_ (financial statement date), we considered its internal control 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 and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

---

*[Engagement Partner]*

---

*[The next page is 7601.]*



# AAM Section 7600

## *Reliance Letter*

### .01 Illustrative Reliance Letter

Addressee:

The following is in response to your letter to our firm dated \_\_\_\_\_ .

We performed an audit of ABC Company's balance sheet dated December 31, 19X0, and the related statements of income, retained earnings, and cash flow for the year then ended. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 19X1 (*audit report date*). No additional audit procedures were performed subsequent to March 28, 19X1.

The audit was conducted in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. However, a properly designed and executed audit may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is an auditor trained to do so. Also audit procedures that are effective for detecting a misstatement that is unintentional may not be effective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

We understand that you intend to rely on the report and associated statements in connection with (*describe as precisely as possible the transaction in connection with which the third party intends to rely on the report and statements*). It should be noted that the audit procedures performed in order to render an opinion on the financial statements of ABC Company may not be adequate or appropriate for this purpose. Because of the limitations inherent in the audit process we may not have detected all material misstatements. Accordingly, our audit was not intended for your benefit and should not be taken to supplant the inquiries and procedures that you should take to satisfy yourself as to ABC Company's credit-worthiness. We recommend that you perform your own due diligence investigation which should include but not be limited to the following steps (*itemize*). We emphasize that this list of procedures may not be all inclusive and that we cannot provide any assurance that the procedures we have mentioned will be sufficient for your purposes.

[Signature]

[Date]

---

[The next page is 7701.]



# AAM Section 7700

## *Proposal Letter*

### .01 Illustrative Proposal Letter

[Date]

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

We appreciate this opportunity to present a proposal for (*nature of services*) and a brief description of our firm and services.

Our firm was formed in 19\_\_\_\_. We have \_\_\_\_ partners and \_\_\_\_ staff and support personnel working with clients in accounting and auditing, taxation, and various consulting services. Although we serve all size clients, our clientele consists primarily of small and medium-size businesses such as yours.

Our professional objectives are to provide the highest quality services on a timely basis. As a member of the AICPA Division for Firm's Private Companies Practice Section, our accounting and auditing practice has been subjected to a review by another firm of CPAs. We received an unqualified opinion as a result of that review. We extend our client relationships to include ongoing contact and services to achieve our services objectives.

We have extensive experience in the \_\_\_\_\_ industry. This experience and related understanding of your industry's operations permit us to design, perform, and complete engagements for your company effectively and at a reasonable cost.

Our services include the following:

- Accounting, Auditing, and Attestation Services

Our accounting, auditing, and attestation services include annual or special audits, compilations and reviews of financial statements, and the examination and review of financial and other information under the attestation standards. We accompany our report on audited financial statements with a reportable conditions letter and a management letter that include suggestions to correct internal control weaknesses and recommendations for operational efficiencies. Our purpose in making these suggestions is to help you accomplish your operational objectives. These suggestions often result in cost savings.

- Tax Services

We offer diversified tax services, including assistance in all phases of federal, state, and local income taxes; estate, inheritance, and gift taxes; and payroll and other taxes. These services include tax return preparation, tax research, and representation of clients at administrative proceedings before the various taxing authorities. The objectives of our tax services are to minimize taxes and potential problems.

- Consulting Services

Our consulting services are designed to assist clients in improving efficiency and profitability. Our approach offers assistance in such areas as developing plans for problem identification or implementing more effective operating controls, evaluating information systems and installing or upgrading data processing systems.

\_\_\_\_\_, an audit partner, will be primarily responsible for your engagement.

As you requested, our proposal is for \_\_\_\_\_ (*state nature of services*).

We estimate that our fees for the proposed services will be approximately \$\_\_\_\_\_, plus out-of-pocket expenses, billable as the work progresses. Our fees are based on time spent on the engagement. Should we encounter any unforeseen circumstances requiring additional time, you will be notified promptly of the situation.

Our fee estimate is based on the assumption that your personnel will prepare certain schedules and analyses for us. We also anticipate their assistance in locating invoices and other documents for our examination.

Our firm is organized and staffed to help you satisfy our business needs. Please call \_\_\_\_\_ with questions about this proposal.

Very truly yours,

\_\_\_\_\_  
[Firm Signature]

\_\_\_\_\_  
[The next page is 8001.]

# AAM Section 8000

## Audit Risk Alerts

The material included in this section is intended to provide auditors with an overview of recent economic, professional, and regulatory developments that may affect audits they perform. The material in this section has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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# AAM Section 8010

## *Audit Risk Alert—1998/99*

### In This Year's Alert...

- What is the purpose of this Audit Risk Alert? What are the risks associated with the audit process?
- What are the current conditions in the U.S. economy?
- Will the Asian crisis have an impact on your audit this year?
- What are some of the accounting and auditing issues that arise in a corporate consolidation?
- What is the year 2000 issue? How will it affect your audits?
- What are the responsibilities of predecessor and successor auditors under the new auditing standard?
- What factors are frequently cited in cases involving improper revenue recognition? What factors might indicate an intentional misstatement of revenues? How are side-agreements used to improperly recognize revenues?
- What will be the impact of Europe's adoption of a new reporting currency?
- What are some of the recurring auditing and accounting issues of concern to the SEC?
- How can auditors adopt a business adviser approach to add value to their audits?
- What are assurance services?
- What are the Auditing Standards Board's operating priorities for the coming years?
- What new auditing and attestation pronouncements have been issued this year?
- What new accounting pronouncements have been issued this year?

\* \* \* \*

### Introduction

*What is the purpose of this Audit Risk Alert?  
What are the risks associated with the audit process?*

.01 This Audit Risk Alert is intended to help auditors plan their 1998 year-end audits. Successful audits are the 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. According to the AICPA SEC Practice Section *Practice Alert* (September 1994) 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

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 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.

## Economic Environment

### *What are the current conditions in the U. S. economy?*

.03 The current economic expansion, now in its eighth year, ranks as one of the nation's strongest growth cycles in almost five decades. The economy's impressive performance during 1998 was clearly demonstrated by key indicators such as the following.<sup>1</sup>

- The nation's unemployment rate, which dropped below 4.5 percent, was near its lowest level in almost thirty years.
- Inflation remained low at a modest 2 percent.
- Consumer confidence reached its highest level in years, thus fueling continued spending. In fact, confidence throughout much of the year was so high that Americans spent 96 cents of every dollar they earned.
- Interest rates remained low by historical standards. For example, average mortgage interest rates on thirty-year fixed loans fell below 7 percent; the federal funds overnight bank lending rate was cut to 5.25 percent by the Federal Reserve Bank in September.
- Gross domestic product (GDP), the broadest measure of total national output, soared to an annualized rate of 5.5 percent for the first quarter. GDP for 1998 was expected to reach 3 percent, despite a decline to 1.4 percent in the second quarter.

Economists expect a number of these conditions to continue into 1999, and are thus predicting another year of economic expansion. Nevertheless, most agree that the pace of growth is likely to moderate, as follows:

- GDP is expected to decline slightly, reaching 2 percent to 2½ percent in 1999.
- Inflation is expected to increase moderately to 2½ percent.
- Job growth should continue, but at a slower pace.
- Unemployment rates are expected to edge up toward 5 percent, but not enough to ease continued labor shortages.

.04 Despite these favorable conditions and forecasts, the *Asian crisis*, as it is commonly called, presents a potential threat to continued domestic growth. The problems in Asia relate to economic instability arising out of the deep and prolonged recessions in countries that include Indonesia, Thailand, South Korea, Singapore, Malaysia, and Japan. These economies have been plagued by rising unemploy-

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<sup>1</sup> Statement on Auditing Standards (SAS) No. 56 *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires the use of analytical procedures in the planning and overall review stages of all audits. Statistical information of the kind shown may be useful to auditors in applying the provisions of SAS No. 56. The appendix—“The Internet—An Auditor's Research Tool,” of this Audit Risk Alert provides a listing of Internet Web sites from which such economic and other financial data may be obtained.

ment, upward pressure on interest rates, and falling asset prices. The resulting declines in currency values and financial markets has led to the weakening or failure of many of their major financial institutions. Moreover, the risk of further adverse developments in Asia remains substantial, with the prospect of economic recovery at least two or three years away. Given the pervasive interconnections of virtually all economies and financial systems in the world today, the associated uncertainties for the U.S. economy remains substantial as well. Although there is no way to know just how much of an impact the Asian crisis will have on the nation, the general sense is that there is a very real danger of an Asia-induced recession.

.05 A likely scenario for such a recession would include the slowing of production and reduced employment levels by U.S. businesses in response to falling export sales, rising inventory levels, and slower domestic sales. Entities with significant reliance on Asian trade, for example, exporters and manufacturers, will be among the first to feel the impact of the crisis. These circumstances could develop as the strength of the dollar makes American-made products more expensive abroad, thus reducing demand. Conversely, currency declines in Asia will make imported cars, clothing, and other items less expensive for Americans. Evidence that this had already happened was reflected in the midyear record high trade deficit showing little demand abroad for U.S. goods while domestic demand for foreign goods was strong. Auditors should understand the implications, direct and indirect, of the Asian economic crisis on their clients. Examples of the audit and accounting issues that might arise are discussed in the section entitled “Current Audit Issues” in this Audit Risk Alert under the heading, “The Asian Crisis—An Auditor’s Perspective.” In addition, auditors may wish to consider what impact, if any, the current economic uncertainties in Russia and Latin America will have on their clients.

.06 Another noteworthy economic event of 1998 has been the unusually high number of corporate consolidations. Across the industry spectrum, from retailing to banking, from pharmaceuticals to insurers, merger and acquisition deals have generated a wave of consolidations dwarfing anything that has preceded it. Driven by the prevailing philosophy that bigger is better in the global marketplace, the value of mergers and acquisitions in the United States through midyear soared by 153 percent from the same point a year earlier, to \$910 billion. Worldwide deals doubled to \$1.3 trillion, rapidly approaching a record \$1.6 trillion for 1997. Thus, in the current environment, auditors are more likely to face the variety of issues that arise out of business combinations. A few examples of matters that could increase audit risk are presented in the section entitled “Current Audit Issues” of this Audit Risk Alert under the heading, “Audit Implications of Business Combinations.”

.07 Numerous reports of improper financial accounting and reporting received widespread coverage in the business media during 1998. Some of these cases involved significant adjustments to previously issued financial statements, some going back several years. One reported incident apparently involved the improper use of merger reserves to create “fictitious” revenues, the fabrication of accounts receivable to inflate reported assets, and other misapplications of generally accepted accounting principles (GAAP), including inappropriate depreciation calculations and the failure to recognize the impact of insurance claims. Another report cited the premature recognition of revenue because of the existence of *side-agreements*, agreements hidden from the entity’s board of directors and outside auditors, that materially altered the terms and conditions of recorded sales. In some of these cases, intentional misstatement of the financial statements—fraudulent financial reporting—is alleged. In others, the accounting is deemed “overly aggressive.”

.08 Another area of concern is the issue of “managing earnings,” that is, the manipulation of accounting practices to ensure that reported financial results meet predetermined expectations. The U.S. Securities and Exchange Commission (SEC) has cited the following five accounting practices that companies employ to manage their earnings:

- “Big bath” restructuring charges, whereby management inappropriately includes in a restructuring charge unrelated charges and accruals
- Creative acquisition accounting (in particular, overly aggressive write-offs of in-process research and development)
- “Cookie jar reserves,” whereby accruals, for the purpose of providing a “cushion” are made in times when earnings are exceeding expectations

- “Immaterial” misapplications of accounting principles, without regard to the qualitative effects
- Premature recognition of revenue

The profession’s self-monitoring mechanisms and investigations undertaken by the SEC confirm that some auditors continue to struggle with these issues. As a result, the SEC met with leaders from the financial reporting, auditing, and standard-setting communities to assess the situation and consider what actions should be taken. The Auditing Standards Board has undertaken a review of the auditing literature to determine whether it needs to be strengthened in the areas of auditing revenues and reserves. The AICPA staff, with the oversight of AICPA technical committees, is preparing a nonauthoritative “toolkit” to help financial statement preparers and auditors better understand issues surrounding revenue recognition, and the AICPA SEC Practice Section Professional Issues Task Force is preparing a Practice Alert, *Revenue Recognition Issues*. These two publications will be available on the AICPA Web site by the end of 1998. In addition, SEC Chairman Levitt’s comments on these and other issues are contained in a recent speech entitled *The Numbers Game*, which is available on the SEC Web site at [www.sec.gov](http://www.sec.gov).

.09 Examining incidents of improper financial accounting and reporting can provide useful lessons for auditors in helping them understand, the following, among other things:

- The manner in which internal control can be circumvented through collusion or management override
- The weakness(es) in internal control that failed to prevent or detect material misstatement on a timely basis
- The audit procedure(s) that might have uncovered the misstatements
- The audit procedure(s) performed that failed to uncover the misstatements
- The presence of fraud risk factors or other conditions that might have alerted the auditors to the possibility that fraud existed

Further discussion of this issue is provided in the section entitled “Current Audit Issues” of this Audit Risk Alert under the heading “Improper Revenue Recognition.” Specific issues of concern to the SEC staff are addressed in other sections of this Alert.

.10 Finally, 1998 brought us yet another year closer to the year 2000 issue. However, not everyone will have to wait until the year 2000 to confront the millenium bug. The year 2000 issue may begin to have an impact on some of your clients this year. For example, auditors should be alert to the fact that some computer systems may have assigned special meanings to date entries coded *xx/xx/98* or *xx/xx/99* (sometimes used for “dummy” transactions intended to test software modifications), and therefore may not process these transactions correctly. Failures may also occur this year if systems perform calculations into or beyond the year 2000. A complete discussion of the year 2000 issue, along with a discussion of some of the updated guidance developed by the AICPA, is presented in the “Current Audit Issues” section of this Audit Risk Alert.

#### **Executive Summary—Economic Environment**

- Now in its eighth year, the current economic expansion ranks as one of the nation’s strongest growth cycles. Economists expect current trends to continue, although the economic crisis in Asia presents a potential threat to continued domestic growth.
- Driven by the philosophy that bigger is better in the global marketplace, 1998 has seen a significant increase in the number of corporate consolidations.
- A number of high-profile cases of improper financial accounting and reporting were widely reported in the business media. The problems were numerous and severe enough to raise concerns with the SEC.
- 1998 brought us another year closer to the year 2000 problem. But for some, year-2000-related problems may arise this year.

## Current Audit Issues

### The Asian Crisis—An Auditor's Perspective

*Will the Asian crisis have an impact on your audit this year?*

.11 The Asian crisis was one of the most significant economic developments in 1998. The deep recessions plaguing a number of Asian countries pose a potential threat to continued growth in various segments of the global economy, including the United States. But to what extent should this be an issue of concern to auditors?

.12 To begin with, auditors should be aware of their responsibilities pursuant to the guidance set forth in Statement of Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). SAS No. 22 requires, in part, that in planning the audit, the auditor should consider matters affecting the industry in which the entity operates, including current economic conditions. As such, auditors should assess the potential impact that the Asian crisis may have on their clients when considering the nature, extent, and timing of work to be performed. Factors to be considered in making the assessment might include whether Asian businesses are among the client's major customers or suppliers, the extent to which the client's product or service competes with low-priced Asian imports, or indirect effects, such as the extent to which a client's major customer is dependent upon Asian trade.

.13 If it appears likely that the Asian crisis may have an impact on any aspect of the client's operations, consideration should be given to the possible audit and accounting issues that might arise. Examples could include the following.

- The collectibility of amounts due from troubled Asian entities or from entities with significant reliance on Asian trade may be called into question. Auditors should carefully consider whether management has properly assessed the collectibility of these receivables, as well as whether adequate consideration has been given to possible loan impairment issues pursuant to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text*, vol. 1, sec. I08).
- Going-concern issues may arise for those entities with significant reliance on Asian trade or for those entities whose major customers have such reliance. In addition, entities whose products compete directly with less expensive Asian imports may also be at risk. In such circumstances, auditors should consider the guidance set forth under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341).
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08), requires that long-lived and certain identifiable intangible assets to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the assets' carrying amount may not be recoverable. For some entities, the Asian crisis may represent a significant adverse change in the business climate that indicates that the recoverability of the carrying amount of an asset should be assessed. Auditors should evaluate management's consideration of FASB Statement No. 121 issues for assets that are directly or indirectly affected by the Asian crisis.
- The appropriate classification of investments in debt and equity securities of Asian entities, or entities with material dealings with Asian entities accounted for under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text*, vol. 1, sec. I80), could be an area of increased audit risk. There may be a greater risk of inappropriate classification of such securities as available-for-sale rather than as trading securities so that any unrealized losses are reported in other comprehensive income rather than in current earnings. SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides auditing guidance for investments accounted for under FASB Statement No. 115, as well as Accounting Principles Board

(APB) Opinion 18, *The Equity Method of Accounting for Investments in Common Stock* (FASB, *Current Text*, vol. 1, sec. I82), and FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations* (FASB, *Current Text*, vol. 1, sec. I82).

- Entities with significant export activities curtailed by the Asian crisis may experience declines in the salability of its inventory and hence its valuation. Auditors should ensure that such inventories have been properly valued at the lower of historical cost (using an acceptable cost-flow assumption) or market.
- Greater risk may be associated with entities involved in Asian foreign-currency-related transactions. Auditors should consider whether management has appropriately accounted for and made all required disclosures relating to foreign-currency translation and transactions arising from the translation of asset and liability positions and revenue and expense transactions in currencies other than the U.S. dollar pursuant to FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60).
- For some clients, the economic impact of the Asian crisis may engender fraud risk factors that suggest an increased possibility of misstatements arising from fraudulent financial reporting. For example, to offset losses incurred from a slowdown in sales to Asian customers, an entity may resort to the inappropriate acceleration of revenue recognition or the improper deferral of expenses. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), sets forth the auditor's responsibilities concerning fraud in a financial statement audit.
- The Asian crisis is likely to result in more risks and uncertainties for many entities, particularly with regard to current vulnerability due to certain concentrations. Auditors should consider whether management has appropriately evaluated all such risks and uncertainties and made the necessary disclosures pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition, auditors should also evaluate management's consideration of related contingencies arising from the Asian crisis, pursuant to FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59).

These examples call attention to some of the possible auditing and accounting implications of the Asian crisis, but should not be viewed as an exhaustive list of all the issues that might arise. Auditors should continue to monitor the crisis and carefully assess its impact on their clients by considering all relevant facts and circumstances.

#### **Executive Summary—The Asian Crisis—an Auditor's Perspective**

- The deep recessions plaguing a number of Asian countries (commonly referred to as the Asian crisis) pose a potential threat to continued growth in various segments of the global economy, including the United States.
- Auditors should assess the potential impact that the Asian crisis may have on their clients when considering the nature, extent, and timing of work to be performed.
- Auditors should consider the possible audit and accounting issues that might arise as a result of the Asian crisis, including going concern, valuation, impairment, collectibility, and fraud.

## **Audit Implications of Business Combinations**

*What are some of the accounting and auditing issues that arise in a corporate consolidation?*

.14 Auditors face a greater likelihood of addressing issues relating to business combinations this year given the surge in corporate consolidations. A business combination, according to Accounting Principles Board (APB) Opinion No. 16, *Business Combinations* (FASB, *Current Text*, vol. 1, sec. B50), occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity that results carries on the activities of the previously separate, independent enterprises. The auditing and accounting issues that arise out of corporate consolidations are numerous and varied. Auditors should carefully consider the individual circumstances of the client to identify those issues and to then develop an appropriate audit strategy. Examples of some of the issues that should be considered by auditors include the following.

- Careful consideration should be given to management's accounting for the business combination to ensure that all relevant GAAP have been considered. For example, if the pooling-of-interests method has been used, have the specific criteria of APB Opinion 16 been met?<sup>2</sup> If not, has the purchase price been allocated to the assets and liabilities acquired with goodwill properly calculated in accordance with the purchase method of accounting? If specialists have been used in asset or liability valuation, auditors relying on such information should consider the guidance set forth under SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). The SEC has viewed the issue of goodwill with some concern recently and, accordingly, audit risk in this area may be especially acute for public companies. Auditors should also be alert to consensus positions reached this year by the FASB's Emerging Issues Task Force (EITF) relating to business combinations. See the "EITF Consensus Positions" section of this Audit Risk Alert for more information.
- With consolidation comes dramatic change in the structure of an entity. In an effort to create greater cost efficiencies in the consolidated entity, departments may be combined and duplicative functions eliminated. Auditors should consider the impact of such changes on their client's internal control when making the assessment of control risk. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit, An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).
- Business combinations often result in the gain of a client for one auditor and a loss of a client for another. Thus, in the current environment, auditors may be more likely to find themselves in the role of either a predecessor or successor auditor. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place. Further discussion of this topic appears in the "Current Audit Issues" section of this Audit Risk Alert.
- Mergers and acquisitions may be effected in part through the use of debt financing. Auditors should carefully evaluate the terms of the debt agreement to identify, among other things, whether there are any loan covenants, and if so, the terms. Auditors should evaluate compliance with restrictive covenants and the implications of any loan covenant violations.
- The acquisition of an entity by one party may mean that another party has disposed of a business segment. Accordingly, auditors of the selling party should consider whether management has followed the accounting and disclosure requirements of APB Opinion 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* (FASB, *Current Text*, vol. 1, sec. I13). Audit risk may be significant for discontinued operations involving an extended phase-out period. Auditors should give careful consideration to management's estimates when the disposal date of the segment occurs after year-end. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.
- Subsequent to the business combination, auditors should consider whether management has prepared the financial statements of the combined entity in accordance with appropriate accounting standards including FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FASB, *Current Text*, vol. 1, sec. C51), and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements* (FASB, *Current Text*, vol. 1, sec. C51).

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<sup>2</sup> Accountants, other than the continuing accountant, who have been requested to provide advice on the application of accounting principles to specified transactions, such as whether a proposed business combination is in compliance with the pooling requirements of APB Opinion 16 and other related GAAP, should refer to the guidance set forth under SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625).

- A business combination involving a public business enterprise may result in an operating segment subject to the disclosure requirements of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. In such circumstances, auditors should consider the guidance set forth under Auditing Interpretation No. 4 of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), "Applying Auditing Procedures to Segment Disclosures in Financial Statements" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.22). See the "New Auditing Interpretations" section for further information about this Interpretation.

#### **Executive Summary—Audit Implications of Business Combinations**

- This year's surge in corporate consolidations suggest that auditors are more likely to face the numerous and varied issues relating to business combinations.
- Auditors should carefully consider the individual circumstances of the client to identify the auditing and accounting issues that arise out of corporate consolidations.
- Auditors should consider the possible auditing and accounting issues that might arise as a result of a business combination, including the accounting methods used, effects on internal control, predecessor and successor communications, and discontinued operations.

### **The Year 2000 Issue**

*What is the year 2000 issue? How will it affect your audits?*

.15 The year 2000 issue relates to the inability of many electronic data processing (EDP) systems to accurately process year-date data beyond the year 1999. This is attributable to the fact that the majority of computer programs in use today were designed to store dates in the date/month/year (dd/mm/yy) format, thus allowing only two digits for each date component. So, for example, the date December 31, 1998, is stored in most computers as 12/31/98. Inherent in programming for dates in this manner is the assumption that the designation 98 refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit-year input fields will cause many computers to treat the entry 00 as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00), as January 1, 1900, and process data incorrectly, or perhaps not at all.

.16 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year 2000 ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur this year. For example, some software programs may have assigned special meanings to entries date coded as xx/xx/98 or xx/xx/99 to allow for the testing of software modifications. Therefore, actual transactions using such dates may not be processed correctly or stop functioning. Failures may also take place currently when systems perform calculations into or beyond the year 2000.

.17 Unless these year 2000 problems are remedied, significant problems relating to the integrity of all electronically processed information based on time will occur. For example, inventory control systems might treat new items as obsolete, receivables may be erroneously identified as past due, interest calculations will be incorrect, paid up insurance policies may be considered expired, computerized equipment maintenance schedules could be affected, as will expiration dates for credit cards and periodical subscriptions, and so on. To further complicate the issue, even if an entity's computer software and hardware are year 2000 ready, the entity may be affected by the computer systems of customers, vendors, or third-party data processing services that have made no such modifications.

.18 Clearly, the year 2000 issue has the potential to adversely affect the operations of entities that rely, directly or indirectly, on information technology. But what are the auditor's responsibilities for the year 2000 issue?



.19 First, it must be understood that it is the responsibility of an entity's management to assess and remediate the effects of the year 2000 issue on an entity's systems—not the auditor's. The year 2000 issue does not create additional responsibilities for the auditor. Under GAAS, 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the year 2000 issue or by some other cause.

.20 Auditing guidance relating to the year 2000 issue has been developed by the Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB). The AITF has issued the following Auditing Interpretations.

- Interpretation No. 4 of AU Section 311, *Planning and Supervision*, "Audit Considerations for the Year 2000 Issue" (AICPA, *Professional Standards*, vol. 1, AU sec. 9311.38), discusses the auditor's responsibility for the year 2000 issue, how it affects planning for an audit of financial statements conducted in accordance with GAAS, and under what circumstances the year 2000 issue may result in a reportable condition under SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).
- Interpretation No. 3 of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls" (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19), clarifies the responsibilities of service organizations and service auditors for information about the year 2000 issue in a service organization's description of controls.
- Interpretation No. 2 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.03), provides guidance regarding the identification and evaluation of conditions and events of the kind identified in SAS No. 59 that relate to the year 2000 issue.

In addition, the AITF issued Attestation Interpretation No. 1 of SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700), "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis" (AICPA, *Professional Standards*, vol. 1, AT sec. 9700.01), that provides guidance on the practitioner's responsibility with respect to year 2000 disclosures.

.21 A summary of these interpretations can be found in the "New Auditing and Attestation Pronouncements" section of this Audit Risk Alert.

.22 Auditors may wish to specifically address the year 2000 issue in connection with obtaining an understanding with their client, pursuant to SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310). SAS No. 83 requires auditors to obtain an understanding with the client about the service to be performed, including the objectives and limitations of an audit of financial statements. With regard to the year 2000 issue, auditors may wish to consider adding language such as the following to their engagement letter:

Because many computerized systems use only two digits to record the year in date fields (for example, the year 1998 is recorded as 98), such systems may not be able to process dates accurately in the year 2000 and after. The effects of this problem vary from system to system and may adversely affect an entity's operations as well as its ability to prepare financial statements.

An audit of financial statements conducted in accordance with generally accepted auditing standards is not designed to detect whether the entity's systems are year 2000 ready. Further, we have no responsibility with regard to the Company's efforts to make its systems, or any other systems such as those of the Company's vendors, service providers, or any other third parties, year 2000 ready or provide assurance on whether the Company has addressed or

will be able to address all of the affected systems on a timely basis. These are responsibilities of the Company's management. However, for the benefit of management, we may choose to communicate matters that come to our attention relating to the year 2000 issue.

The auditor also may wish to consider whether year-2000-related problems should be highlighted in his or her management comment letters. Through inquiries of client personnel, the auditor may obtain information regarding the client's understanding of the year 2000 issue and, if applicable, the progress of its year 2000 project efforts. The auditor may wish to communicate to senior management and the audit committee the results of such inquiries and any observations regarding the year 2000. However, auditors should be cautious in these communications not to imply an assumption of assuring year 2000 readiness.

.23 Depending on the entity's reliance on date-dependent processing and the state of preparedness for the year 2000, the auditor also may want to address certain other situations relating to the year 2000 issue in his or her management letter. Situations such as the following may occur.

- The client has not begun to address the year 2000 issue. The client recognizes the issue but needs to develop a year 2000 project plan.
- The client recognizes the issue but needs to assess the effect of the year 2000 issue on its systems.
- The client needs to consider the budget and resource implications of the plan.
- The client is not currently meeting its year 2000 project plan timetables.

.24 Auditors should also be alert to the numerous accounting considerations that arise out of the year 2000 issue. For example, auditors should consider whether the costs associated with their client's modifications of computer systems pursuant to the year 2000 issue have been properly accounted for. The EITF has considered this matter in EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*. This issue addresses accounting for the external and internal costs specifically associated with the modification of internal use computer software for the year 2000. The issue does not address purchases of hardware or software that replace existing software that is not year 2000 ready, nor does it address impairment or amortization issues relating to existing assets. The task force reached a consensus that external and internal costs specifically associated with modifying internal use software for the year 2000 should be charged to expense as incurred. In addition, EITF Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, provides relevant guidance when an entity's year 2000 project involves business process reengineering.

.25 The year 2000 issue may render certain client assets (such as computer hardware and software) obsolete or inoperable. Accordingly, auditors may wish to consider whether the client has properly accounted for such events by appropriately adjusting useful lives, residual values, or both, or recognizing impairment losses pursuant to the guidelines set forth under FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.

.26 Other accounting issues that may arise include the following:

- Revenue recognition principles for software transactions are set forth in AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition*. This SOP provides guidance on the amount and timing of revenue recognition in arrangements that may include the presence of specific factors, including uncertainty of customer acceptance; customer cancellation privileges; and multiple elements, including upgrades and enhancements and postcontract customer support. Entities should be aware that the year 2000 issue could affect one or more of these factors and have an unexpected effect on future revenue recognition.
- The year 2000 issue may create product warranty and product defect liability and product returns issues for software and hardware vendors. These vendors should consider FASB Statement No. 5,

*Accounting for Contingencies*, paragraphs 24 to 26, if there are product warranty or product defect liability issues and FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (FASB, *Current Text*, vol. 1, sec. R75), for product return issues.

- Software developers should evaluate arrangements to address the year 2000 issue performed for other entities for a fee that are being accounted for under SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. For any contract expected to result in a loss, the vendor should record a provision for the entire loss in the period in which it becomes evident.
- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* (FASB, *Current Text*, vol. 2, sec. Co2), is the authoritative standard on accounting for costs incurred to produce or purchase software that is to be sold, leased, or otherwise marketed. Only certain costs qualify for capitalization under this standard. In accordance with the guidance in the Statement, a write-down or an acceleration of amortization may be necessary if estimated future gross sales are lower than expected because of the year 2000 issue.
- Inventories of hardware devices that are not year 2000 ready would be subject to the lower of cost or market test described in ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 4, paragraph 8 (FASB, *Current Text*, vol. 1, sec. I78).
- In addition to the disclosure requirements under the pronouncements previously mentioned, practitioners should be aware of the requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Although the need for disclosure by an entity depends on facts and circumstances, disclosure may be required in areas such as impairment or amortization of capitalized software costs, inventory valuation, long-term contract accounting, or litigation if it is reasonably possible that the amounts reported in the financial statements could change by a material amount within one year from the date of the financial statements. Disclosures also may be required of current vulnerability due to certain concentrations if, for example, a significant vendor has not satisfactorily addressed the year 2000 issue.

.27 Auditors of publicly held companies should consider the guidance set forth by the SEC in its Interpretation entitled “Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers,” (the Interpretation). The Interpretation—

- Provides guidance to public companies so they can determine whether their year 2000 issues are known material events, trends, or uncertainties that should be disclosed in the Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) section of their disclosure documents.
- Sets forth SEC guidance regarding specific matters for companies to address in their MD&A year 2000 issue disclosure.
- Addresses the need for companies to consider the year 2000 issue in connection with other rules and regulations and when they prepare financial statements.
- Reminds registrants that the antifraud provisions of the federal securities laws apply to disclosure about the year 2000 issue.

The Interpretation supersedes the guidance previously set forth in the revised Staff Legal Bulletin No. 5. The full text of the Interpretation can be viewed on the SEC Web site, <http://www.sec.gov>.

.28 Auditors should also be aware of the risk of litigation relating to the year 2000 issue. Some clients may be uninformed about the year 2000 issue, while others may underestimate its magnitude. Those who mistakenly believe that the year 2000 issue should be addressed and resolved as part of the audit process may seek legal recourse if that outcome is not achieved. Therefore, auditors may wish to educate their clients

on the year 2000 issue and its implications. As previously discussed, auditors may wish to incorporate these issues in the engagement letter by outlining the responsibilities of both the client and the auditor. By advising the client and planning ahead, auditors may avoid any potential dispute with the client, while at the same time offering the opportunity of helping the client understand the seriousness of the problem and identifying resources that may be needed to address the issues.

.29 A more comprehensive discussion of the numerous auditing and accounting issues related to the year 2000 issue is presented in the AICPA publication "The Year 2000 Issue— Current Accounting and Auditing Guidance."<sup>3</sup> The publication has been updated for recent developments and provides a wealth of information for auditors including discussions relating to the following:

- Introduction to and implication of the year 2000 issue
- Industry specific considerations
- Financial reporting issues
- Auditing issues
- Disclosure considerations
- Auditor communications
- Practice management issues

This document can be obtained, free of charge, at the AICPA's Web site at <http://www.aicpa.org>. The AICPA Web site provides a year 2000 resource page with links to many useful sites as well. Additional information relating to the year 2000 issue is also available on the Internet at the following Web sites:

- The National Bulletin Board for the Year 2000 at <http://www.year2000.com>
- Management Support Technology at <http://www.mstnet.com/year2000>
- National Software Testing Laboratory at <http://www.nstl.com> (free downloadable diagnostic program)

In addition, the AICPA publication, *Accounting Trends and Techniques—1998* (Product No. 009890), contains examples of year 2000 issue financial statement disclosures made by publicly held entities.

#### **Executive Summary—The Year 2000 Issue**

- Unless corrective actions are taken, the year 2000 may cause accounting and financial information systems to produce inaccurate date related output.
- The AITF has issued Interpretations providing guidance to auditors on the year 2000 issue.
- Auditors may wish to include references to the year 2000 issue in their engagement and management letters.
- Auditors should consider client accounting for the year 2000 issue pursuant to such pronouncements as EITF Issue No. 96-14; SOP Nos. 81-1, 94-6, and 97-2; ARB 43; and FASB Statement Nos. 5, 48, 86, and 121. For publicly held entities, SEC rules and regulations should be considered.
- Auditors should be alert to the litigation threats that may arise from the year 2000 issue.

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<sup>3</sup> With regard to this publication, the SEC Interpretation on year 2000 issues states that "Although the term may is used throughout the AICPA's guidance, perhaps suggesting that the guidance is discretionary, we believe that the procedures outlined by the AICPA should be considered appropriate practice at this time and we expect companies and their auditors to comply with that guidance. If they do not, they should be prepared to justify why the procedures were not followed."

## A Change of Auditors

### *What are the responsibilities of predecessor and successor auditors under the new auditing standard?*

.30 With the increasing level of consolidation activity comes a corresponding increase in changes in auditors. Thus, auditors may be more likely to find themselves in either the role of a predecessor or successor auditor this year. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), which superseded SAS No. 7 of the same name, provides guidance in communications between predecessor and successor auditors when a change of auditors is in process or has taken place.

.31 To begin with, SAS No. 84 redefines the terms *predecessor* and *successor* auditors. A predecessor auditor (the predecessor) is defined as an auditor who—

1. Has reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of any subsequent financial statements.
2. Has resigned, declined to stand for reappointment, or been notified that his or her services have been, or may be, terminated

A successor auditor (the successor) is defined as an auditor who is considering accepting an engagement to audit financial statements but has not communicated with the predecessor auditor, as required by SAS No. 84, and to an auditor who has accepted such an engagement.

.32 SAS No. 84 cites as a necessary procedure on the part of the successor, the inquiry of the predecessor. The successor, upon receiving permission from the prospective client, should make specific and reasonable inquiries of the predecessor regarding matters that will assist the successor in determining whether to accept the engagement. Though the successor may consider making any reasonable inquiry, SAS No. 84 requires that matters subject to inquiry should include the following:

- Information that might bear on the integrity of management
- Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters<sup>4</sup>
- Communications to audit committees or others with equivalent authority and responsibility regarding fraud, illegal acts by clients, and internal-control-related matters
- The predecessor's understanding as to the reasons for the change of auditors

The predecessor should respond promptly and fully to the successor's reasonable inquiries. If, due to unusual circumstances, the predecessor decides to offer a limited response, this fact should be clearly stated. The successor should consider the implications of a limited response in deciding whether to accept the engagement.

.33 SAS No. 84 also states that the successor should request the client to authorize the predecessor to allow a review of his or her working papers. (An illustrative client consent and acknowledgement letter documenting this authorization is included in SAS No. 84.) The successor's review of the predecessor's working papers may affect the nature, timing, and extent of the successor's procedures with respect to the opening balances and consistency of accounting principles. However, the work performed and the conclusions reached are solely the responsibility of the successor. The predecessor should ordinarily permit the successor to review his or her working papers, but SAS No. 84 provides that the extent, if any, to which a predecessor permits access to the working papers is a matter of judgment.

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<sup>4</sup> The SEC's Chief Accountant noted at the July 9, 1998, joint meeting of the AICPA SEC Regulations Committee with the SEC staff that a successor auditor who agrees with the proposed accounting treatment that led to the resignation or dismissal of a predecessor auditor should contact the SEC staff prior to accepting the audit engagement. He added that the staff would be "very interested and concerned" if a successor auditor allowed an accounting treatment that a predecessor auditor did not.

.34 SAS No. 84 also discusses audits of financial statements that have been previously audited, as well as providing communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor. Auditors who find themselves in the role of predecessor or successor auditors should refer to the full text of SAS No. 84 to determine the extent of their responsibilities under GAAS. SAS No. 84 became effective with respect to the acceptance of engagements after March 31, 1998.

#### **Executive Summary—A Change of Auditors**

- The increase in consolidation activity this year suggests that auditors will be more likely to become successor or predecessor auditors.
- SAS No. 84 provides guidance on communications between predecessor and successor auditors.
- SAS No. 84 also addresses issues such as a review of predecessor working papers, previously audited financial statements, discovery of misstatements by the successor, as well as providing illustrative letters for predecessor-or-successor-related communications.

### **Improper Revenue Recognition**

*What factors are frequently cited in cases involving improper revenue recognition?*

*What factors might indicate an intentional misstatement of revenues?*

*How are side-agreements used to improperly recognize revenues?*

.35 High-profile incidents of improper revenue recognition reported during 1998 should serve to remind auditors of the significant risks that may be associated with this area of the financial statements. Auditors should consider whether what appear to be routine revenue transactions have been properly accounted for; however, greater levels of audit risk may more likely be associated with unusual or complex revenue transactions, especially those that occur at or near the end of a reporting period. Therefore, auditors should have a sufficient understanding of the nature of the entity's business to be able to distinguish routine transactions from those that are unusual or complex.

.36 Auditors should be alert for significant unusual or complex transactions, especially those that occur at or near the end of a reporting period. Also suspect are high volumes of revenues recognized in the last few weeks—or days—of a reporting period. The following are examples of additional circumstances of concern to auditors regarding the issue of recognition of revenue:

- Sales for which the customer has a right to return the goods
- Partial shipments if the portion not shipped is a critical component of the product
- Revenue transactions with related parties
- Lack of involvement by the accounting or finance department in unusual or complex sales transactions
- Sales in which evidence indicates the customer's obligation to pay for the merchandise depends on the following:
  - Receipt of financing from another party
  - Resale to another party (meaning, sale to distributor, or a consignment sale)
  - Fulfillment by the seller of material unsatisfied conditions
  - Final acceptance by the customer following an evaluation period
- Existence of longer than usual payment terms or installment receivables
- Sales terms do not comply with the company's normal policies
- Sales that require substantial continuing vendor involvement after delivery of merchandise (for example, software sales requiring installation, debugging, extensive modifications, or other significant support commitments)

- Shipments of merchandise to customers without proper authorization from the customer
- Shipments of merchandise to company-owned warehouses
- Billing fictitious customers
- Shipments made on canceled or duplicate orders
- Pre-invoicing of goods in process of being assembled or invoicing prior to or in the absence of actual shipment

.37 Not all instances of improper revenue recognition involve the intentional misstatement of the financial statements. Management's use of aggressive accounting policies may reflect their understanding of the substance of the transactions and the consistency with which their policies reflect industry practices. Others with an independent perspective (such as auditors or regulators) may determine that such accounting policies are inappropriate. Thus, auditors should be aware of the possibility that revenues are misstated even if there is no indication that management might intend to deceive. However, auditors also should consider whether there is a risk that the entity has intentionally misstated the financial statements.

.38 What factors might indicate an intentional misstatement of revenues? Statement on Auditing Standards No. 82, *The Auditor's Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), requires auditors to assess the risk of material misstatement of the financial statements due to fraud. As a part of that assessment, the auditor is required to consider whether fraud risk factors are present. The following are examples of fraud risk factors included in SAS No. 82 that are relevant to the audit of revenues.

- There is a motivation for management to engage in fraudulent financial reporting. Specific indicators might include the following:
  - A significant portion of management's compensation is 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.
  - Management is excessively interested in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
  - Management makes a practice of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts.
- Management fails to display and communicate an appropriate attitude regarding internal control and the financial reporting process. Specific indicators might include the following:
  - An ineffective means of communicating and supporting the entity's values or ethics, or communication of inappropriate values or ethics
  - Unduly aggressive financial targets and expectations set by management for operating personnel
  - A significant disregard by management for regulatory authorities
- Rapid changes occur in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence.
- There is an inability to generate cash flows from operations while reporting earnings and earnings growth.
- Assets, liabilities, revenues, or expenses are based on significant estimates that involve unusually subjective judgments or uncertainties, or are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity such as ultimate collectibility of receivables, timing of revenue recognition, realizability of financial instruments based on the highly subjective valuation of collateral or difficult-to-assess repayment sources, or significant deferral of costs.

- Unusually rapid growth or profitability, occurs especially compared with that of other companies in the same industry.
- Unrealistically aggressive sales or profitability incentive programs exist.

If these or other fraud risk factors are present, the auditor is required to make certain considerations, as outlined in SAS No. 82. Above all, the auditor should maintain an appropriate attitude of professional skepticism. Specific responses to these risks might include the assignment of more senior or experienced personnel to plan and perform the auditing procedures related to revenues, increased sensitivity in the selection of the nature and extent of documentation to be examined, and increased recognition of the need to corroborate management explanations or representations. Additional guidance on the response to the presence of fraud risk factors is contained in SAS No. 82 and in the AICPA publication, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883).

**.39** How are side agreements used to improperly recognize revenues? One specific example of fraudulent financial reporting involves the use of *side-agreements*—agreements hidden from the entity's board of directors and outside auditors. Side-agreements are used to alter the terms and conditions of recorded sales transactions to entice customers to accept delivery of goods and services. They may create obligations or contingencies relating to financing arrangements or to product installation or customization that may relieve the customer of some of the risks and rewards of ownership.

**.40** Typically, very few individuals within an entity are aware of the use of side-agreements. Although side-agreements may be difficult to discover, auditors should consider their possible existence. SAS No. 82 states that, "If there is a risk of material misstatement due to fraud that may involve or result in improper revenue recognition, it may be appropriate to confirm with customers certain relevant contract terms and the absence of side-agreements—inasmuch as the appropriate accounting is often influenced by such terms or agreements. For example, acceptance criteria, delivery and payment terms and the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in the circumstances." Because it is unlikely that alternative procedures to nonreplies will provide information relevant to the existence of side-agreements, auditors should make reasonable efforts to obtain responses.

**.41** What kinds of auditing procedures will help uncover the improper recognition of revenue? The following are examples of procedures auditors can apply to the audit of revenues.

#### *Planning*

As mentioned earlier, it is important for the auditor to understand the client's industry and business. The understanding would include the kinds of products and services sold, and the client's terms and the industry's customary terms over their sales. The auditor also obtains an understanding of the controls surrounding the shipment of goods and the recognition of revenue.

#### *Assignment of Personnel*

Unusual or complex sales contracts may call for consideration by more experienced audit personnel.

#### *Physical Observation*

In connection with the observation of inventories at the end of a reporting period, auditors frequently obtain information pertaining to the final shipments of goods made during the period. This information later is compared to the client's sales records to determine whether a proper cut-off of sales occurred. Additional procedures include inspecting the shipping areas at the observation site and making inquiries about whether goods in the shipping area will be included in inventory. If they are not to be included in inventory, the auditor may need to obtain information about the nature of the goods and the quantities, and make additional inquiries of management. Auditors also might inspect the site to determine if any other inventory has been segregated.



### *Inquiry of Relevant Personnel*

In many instances, particularly those involving unusual or complex transactions, the auditor should consider making inquiries of marketing, inventory control personnel, and other client personnel familiar with the transactions to gain an understanding of the nature of the transactions and any special terms that may be associated with them. Inquiries of legal staff also may be appropriate. In some circumstances, the auditor may wish to obtain written representatives from such personnel.

### *Analytical Procedures*

Well-planned and detailed analytical procedures used in planning the audit and as substantive tests can identify situations that warrant additional consideration. Examples of these procedures include monthly or weekly analyses of sales volume, comparison of sales volume to prior periods, ratio of sales in the last month or week to total sales for the quarter or year, and the client's record of making or exceeding budgeted sales amounts.

### *Confirmations*

Standard confirmation requests (confirming only the outstanding balance) alone do not always provide sufficient evidence that only appropriate revenue transactions have been recorded. Auditors should consider the need to confirm significant terms of contracts and whether to inquire about the existence of oral or written contract modifications (side-agreements).

### *Reading and Understanding the Contracts*

In many entities, the majority of sales are made pursuant to standard terms and is not evidenced by other than the normal purchase orders and shipping documentation. In addition to understanding the client's normal terms of sale, the auditor should read and understand contracts related to those significant transactions that are unusual or complex. In some entities, the majority of revenues are comprised of complex transactions evidenced by individual contracts. In these circumstances, the need for the auditor to read and understand individual contract terms may be increased.

### **Executive Summary—Improper Revenue Recognition**

- High-profile incidents of improper revenue recognition reported during 1998 should serve to remind auditors of the significant risks that may be associated with this area.
- Auditors should be alert for significant unusual or complex transactions, especially those that occur at or near the end of a reporting period, along with a variety of other circumstances that may raise concerns about improper revenue recognition.
- Auditors should be alert to the possible existence of *side-agreements*, agreements hidden from the entity's board of directors and outside auditors that may have an impact revenue recognition.
- Auditors should consider the issue of revenue recognition with regard to its impact on engagement planning, assignment of personnel, physical observation, inquiry of relevant personnel, analytical procedures, confirmations, and reading and understanding contractual arrangements.

## **Europe's New Reporting Currency—The Euro**

### *What will be the impact of Europe's adoption of a new reporting currency?*

**.42** On January 1, 1999, the European Economic and Monetary Union (EMU) goes into effect. Under the EMU, only one reporting currency will exist—the Euro. From that point on, every entity that trades with or has subsidiaries in Europe will be affected by the change to a common currency.

**.43** Under the current system, published currency exchange rates and cross-currency exchange rates are used to convert, for example, the U.S. dollar into the German Deutschmark and the Deutschmark into the French franc, respectively. Under the new system (a process called *triangulation*), the old currencies will continue to exist for a three-and-a half year transition period, but the only published exchange rates will be

that of the Euro. Accordingly, the conversion of U.S. dollars to Deutschmarks will involve an intermediate step—first dollars to Euros using published exchange rates, then Euros to Deutschmarks using official published conversion rates (which will be finalized on December 31, 1998).

.44 The implications for computerized accounting systems is clear. All software designed for the current system will have to be modified to convert, for example, U.S. dollars to Euros (using daily exchange rates), and then to convert the Euro into the national currency, such as the Deutschmark. Although there is uncertainty as to the cost and impact of the EMU on financial information systems, some are predicting that it may be more demanding than the year 2000 issue. In addition, addressing the problem may be difficult, given that a significant level of technology-related resources are now being allocated to resolve the year 2000 issue.

.45 Many U.S. companies have paid little attention to the implications of the Euro—which are numerous and detailed—because they are focusing on year 2000 problems. Accordingly, auditors should consider the increased risks that may be associated with this issue. For auditors of entities issuing calendar year-end financial statements, the impact of the Euro will likely be limited to type II subsequent events that may require financial statement disclosure, as discussed in “Subsequent Events” (AICPA, *Professional Standards*, vol. 1, AU sec. 560). However, auditors of entities issuing financial statements for fiscal years ending after January 1, 1999, should consider the following:

1. The audit risks that may be associated with management’s accounting for foreign-currency transactions involving the Euro,
2. Control risk assessment relating to the Euro, such as revamped information systems or changes in foreign operations,
3. The fraud risk factors that might arise with the adoption of the Euro, along with the adequacy of financial statement disclosures that may be required in the circumstances.

FASB Staff Announcement, Topic D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union (EMU)*, discusses upgrade costs for projects to adapt information systems software for the Euro, and the preparation of comparative financial statements if there has been a change in reporting currency to the Euro. In addition, the SEC’s Divisions of Corporation Finance, Market Regulation, and Investment Management issued Staff Legal Bulletin No. 6, which provides guidance on Euro-conversion-related issues such as the disclosure requirements that could arise.

## SEC Concerns

*What are some of the recurring auditing and accounting issues of concern to the SEC?*

.46 During informal discussions with representatives of the AICPA, the SEC staff have expressed concerns with regard to certain recurring auditing and accounting issues that they have encountered. Auditors of entities subject to the SEC reporting requirements may wish to consider the issues discussed below.

### ***Disclosures About Restructuring Charges and Liabilities Recognized in Connection With Purchase Business Combinations***

.47 When liabilities are accrued in accordance with the guidance in EITF Issues Nos. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, and 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*, certain disclosures are required. The thresholds for making the required disclosures are related to the materiality of the amounts accrued or the significance of the activities that will not be continued. Therefore, when the disclosure thresholds have been met, all the disclosures are required, not just those that are individually material.

.48 Some of the disclosures are required until the plan of termination is completed or until all actions under a plan to exit an activity or involuntarily terminate employees of an acquired company have been fully

executed. For instance, under EITF Issue No. 94-3, the amount of actual termination benefits paid and charged against the liability and the number of employees actually terminated as a result of the plan to terminate the employees must be disclosed. The amount of any adjustments to the liability also must be disclosed.

.49 The SEC staff have observed an increasing frequency of subsequent reductions to restructuring liabilities, which suggests that management may be “providing a cushion” in establishing such reserves. When reviewing management’s accruals, auditors should be aware of the kinds of charges that are allowed to be accrued for pursuant to EITF Issue Nos. 94-3 and 95-3 (and other relevant accounting literature, as appropriate), and be mindful that management’s estimates are not overly conservative.

.50 Additionally, the SEC staff have stated that liabilities accrued in accordance with EITF Issues Nos. 94-3 and 95-3 are valuation accounts that should be disclosed on Schedule VIII, Valuation and Qualifying Accounts, of SEC Registrants’ annual reports filed on Form 10-K.

### ***Accounting for Impairment of Long-Lived Assets***

.51 FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, requires entities to review long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Statement provides examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of an asset should be assessed. The SEC staff have identified instances in which they believe the accounting guidance in FASB Statement No. 121 has been applied inappropriately. For example, a significant change in the manner in which an asset is used may initiate management’s assessment and the recognition of an impairment loss. The SEC staff believe some of these charges are the result of the failure of management to make appropriate and timely changes to depreciable lives needed as a result of other events—general economic or industry conditions, for example—that may cause the remaining estimated useful lives of assets to decrease. Such changes should be accounted for as changes in estimates in accordance with APB Opinion 20, *Accounting Changes*. APB Opinion 20 specifically lists service lives of depreciable assets as an example of items for which estimates are necessary. Auditors may wish to discuss with management the procedures used to periodically monitor the remaining estimated useful lives of significant classes of long-lived assets.

### ***Communicating With the Audit Committee***

.52 SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), requires auditors to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. Communication about significant accounting policies is one of the matters outlined in SAS No. 61. In some recent instances in which the SEC staff have questioned the accounting used by a registrant, the SEC staff have found that neither the auditor nor management had consulted with the registrant’s audit committee prior to meeting with the SEC staff to discuss the accounting. Although for a variety of reasons, including timing, this situation may not be indicative of a violation of the auditing standards, the SEC staff suggest that this situation is not desirable. They strongly recommend that management discuss significant issues raised by SEC staff with both the auditor and the audit committee. In situations in which the auditor will participate in discussions with the SEC staff and management, it is advisable for the auditor to participate in any discussions management has with the audit committee or be apprised of the substance of those discussions.

.53 The following is an excerpt from SAS No. 61.

#### **Significant Accounting Policies**

.07 The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or their application. The auditor should also determine that the audit committee is informed about the methods used to

account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. For example, significant accounting issues may exist in areas such as revenue recognition, off-balance-sheet financing, and accounting for equity investments.

## Other Practice Issues

### Make Audits Pay

*How can auditors adopt a business adviser approach to add value to their audits?*

.54 As a mature product, the audit has some attributes of a commodity, distinguishable to many clients only on the basis of price. Accordingly, many CPAs are recognizing the need to broaden their audit practice by providing consulting services to their clients. But what approach should auditors use to enter the consulting field?

.55 One choice is the business adviser approach. This approach provides clients with consulting services driven by customer need. Although the most common tack is to develop a consulting product first, and then try to sell that product to the audit client, the business adviser approach starts by identifying customer needs. Once those needs have been identified, specific guidance is presented to the client. This allows the auditor to provide the client with total business solutions that are more valuable than off-the-shelf consulting products.

.56 The business adviser approach uses the audit to understand the client and identify needs across a broad range of business issues. The auditor using the business adviser approach should—

- Understand the client's business processes, not just the client's accounting systems.
- Analyze the client's industry according to how it affects the client's business plan, in addition to how it affects audit risk.
- Identify client needs across a broad range of business issues and offer suggestions for addressing those needs.
- Engage the client in a dialogue about broad business matters, in addition to matters of audit significance.

These procedures will identify not only new consulting opportunities, the deeper insights gained into client operations will also improve audit effectiveness and efficiency.

.57 With this knowledge in hand, the auditor can use existing firm resources, including the relationship with the client, knowledge of the client and the industry in which it operates, and in-firm expertise, to incrementally and selectively build a consulting practice. Auditors can build on strengths and skills they already have in areas in which business owners would most naturally look to a CPA for advice, such as cost analysis and reduction, internal control, information management, and technology.

.58 The basic steps in the business adviser process are the following.

- *Target selected clients.* Choose those clients from which a reasonable return on investment can be expected,
- *Develop a strategy with the audit team.* Develop a tentative plan for identifying client needs,
- *Conduct a dialogue with the client.* Meet with the client to discuss plans for implementing the business adviser program,
- *Conduct the audit considering client needs.* Perform the audit and identify client needs while developing possible solutions over a wide range of business issues.

For further information on this subject, the AICPA publication, *Make Audits Pay: Leveraging the Audit into Consulting Services*, provides a detailed roadmap for auditors interested in adopting the business adviser approach for providing consulting services to their clients. Included in the book are diagnostic practice aids to help identify client needs along with recommended solutions. This publication will be available in early 1999.

## Assurance Services

### *What are assurance services?*

.59 The AICPA's Special Committee on Assurance Services (the Committee), whose charge was to assess the economics of auditing and its likely future, concluded that financial statement auditing is no longer a growth industry. In response, after extensive research, the Committee concluded that there are opportunities for additional work in the audit tradition, suggesting that a wider variety of assurance engagements could be offered. The Committee defines these assurance services as independent professional services that improve the quality of information or its context for decision makers. This information can be financial or nonfinancial, historical or prospective. In recognition of the importance of assurance services, the ASB has established a strategic initiative to broaden the utility of the attestation standards to facilitate new assurance services that respond to emerging user needs.

.60 The Committee has identified six new assurance services for which business plans were developed. The business plans assessed the market potential of each service, and identified the steps that CPAs should take to begin offering these services. The services identified by the Committee are the following.

- *Risk assessment.* This service provides assurance that an entity's profile of business risks is comprehensive and evaluates whether the entity has appropriate systems in place to effectively manage those risks.
- *Business performance measurement.* This service evaluates whether an entity's performance measurement system contains relevant and reliable measures for assessing the degree to which the entity's goals and objectives are achieved.
- *Information systems reliability.* This service assesses whether an entity's internal information systems (financial and nonfinancial) provide reliable information for operating and financial decisions.
- *Electronic commerce.* This service assesses whether the systems and tools used in electronic commerce provide appropriate data integrity, security, privacy, and reliability.
- *Health care performance measurement.* This service provides assurance about the effectiveness of health care services provided by health maintenance organizations, hospitals, doctors, and other providers.
- *ElderCare.* This service assesses whether specified goals regarding care for the elderly are being met by various caregivers. The AICPA publication *CPA ElderCare: A Practitioner's Resource Guide* (Product No. 002504) provides valuable information to assist in conducting this kind of assurance service engagement.

Seven other assurance services, viewed as good opportunities but for which the Committee did not develop business plans, have also been described. They are policy compliance, trading partner accountability, mergers and acquisitions, outsourced internal auditing, ISO 9000, Association for Investment Management and Research (AIMR) compliance, and World Wide Web assertions.

.61 The Assurance Services Executive Committee was given the charge of carrying on the work of the Special Committee on Assurance Services in identifying and developing new assurance services for the profession. Readers should refer to the AICPA Web site at <http://www.aicpa.org> for the full report of the Special committee on Assurance services. In addition, the AICPA is hoping to develop a new series of Alerts during 1999 that address the emerging practice area of assurance services.

## Strategic Initiative of the ASB

### *What are the Auditing Standards Board's operating priorities for the coming years?*

.62 In recognition of the many challenges facing the profession, the ASB undertook to consider its priorities and establish a set of initiatives to serve as a planning tool for its activities over the next few years. In developing these strategic initiatives, the ASB, through its Horizons Task Force, considered major trends affecting the profession, notably the following:

- The impact of information and communications technology, internationalism, and the inroad of non-CPAs into the provision of assurance services
- Significant recent recommendations from both within and outside the profession
- The strategic initiatives adopted by the AICPA

The result of the task force's deliberation was a document titled "Horizons for the Auditing Standards Board—Strategic Initiatives Toward the Twenty-First Century" (Horizon report), in which the ASB defines the following priorities for its operational plan over the next three to five years.

1. Improve the core audit service to serve the public, the preparers, and the profession through the following:
  - The use of information technology, with the ultimate objective of providing real-time assurance on the systems and processes that generate outputs
  - An improvement in meeting public expectations about audit assurance, including evaluation of the efficacy of the fraud standard
  - The delivery of value-added services to enhance and differentiate audit engagements
2. Broaden the utility of the attestation standards to facilitate new assurance services that respond to emerging user needs. Key actions are to do the following.
  - Establish a framework for attestable measurement criteria for use by industry associations, regulatory bodies, and others to facilitate development of new attestation services.
  - Increase the understandability and flexibility of the attestation model.
3. Significantly strengthen the ASB's leadership role in developing international auditing standards and quality control processes that meet the needs of a global marketplace. A subcommittee of the ASB will be created to do the following.
  - Participate directly in, or identify U.S. volunteer participants for, the development of specific International Standards on Auditing (ISAs).
  - Identify and promote opportunities for joint projects with other audit or attest standards setters.
  - Recommend changes regarding significant differences between U.S. and international auditing and attestation standards and the processes by which they are developed.
  - Recommend changes regarding significant differences between U.S. and international standards and processes regarding professional qualification, quality control, ethical standards, and peer review.
  - Develop a strategy for the eventual endorsement of international auditing standards.
4. Enhance the utility of audit and attest guidance by implementing process improvements in ASB operations. ASB actions will include the following.
  - Simplify and clarify the various kinds of guidance and enhance their accessibility.
  - Implement process improvements in ASB operations.

The ASB's Horizon report can be viewed in its entirety at the AICPA's Web site at <http://www.aicpa.org/members/div/auditstd/horizon/index.htm>.

## New Auditing and Attestation Pronouncements

*What new auditing and attestation pronouncements have been issued this year?*

### New Auditing Standards

#### **SAS No. 86, Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties**

.63 SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), was issued in March 1998 by the ASB to reflect the issuance of SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners that have examined or reviewed MD&A in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

#### **SAS No. 87, Restricting the Use of an Auditor's Report**

.64 SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), was issued in September 1998 by the ASB and is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The SAS states that an auditor should restrict the use of a report if the following occur.

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used in restricted-use reports, and requires an auditor to restrict a single combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

#### **SAS No. 21, Segment Information—Rescinded**

.65 SAS No. 21, *Segment Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 435), contained guidance for auditing disclosures made in accordance with the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 was superseded upon the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30), which is effective for fiscal years beginning after December 15, 1997 with earlier application encouraged. Accordingly, the ASB has rescinded SAS No. 21 effective for audits of financial statements to which FASB Statement No. 131 has been applied. In its place,

Auditing Interpretation No. 4 of SAS No. 31, *Evidential Matter*, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," has been issued. See the "New Auditing Interpretations" section of this Audit Risk Alert for a more detailed discussion of the new Interpretation.

.66 Statements of Position issued this year by the ASB are included in the section entitled "New AICPA Statements of Position" in this Audit Risk Alert.

.67 And don't forget the following ASB pronouncements that became effective during 1998:

- SAS No. 83, *Establishing an Understanding With the Client* (effective for engagements for periods ending on or after June 15, 1998)
- SAS No. 84, *Communications Between Predecessor and Successor Auditor* (effective for engagements accepted after March 31, 1998)
- SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333) (effective for audits of financial statements for periods ending on or after June 30, 1998)
- SSAE No. 7, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AT sec. 100) (effective for engagements for periods ending on or after June 15, 1998)

## New Attestation Standard

.68 *SSAE No. 8, Management's Discussion and Analysis*. Issued by the ASB in March 1998, SSAE No. 8 (AICPA, *Professional Standards*, vol. 1, AT sec. 700) provides guidance to a practitioner on the performance of a review or examination of MD&A prepared pursuant to the rules and regulations of the SEC. The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8 provides the following:

- Conditions for engagement performance for both examinations and reviews of MD&A
- Extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A
- A comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8

SSAE No. 8 became effective upon issuance.

.69 In September 1998, the ASB voted to issue the exposure draft *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity's Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation* as a final standard. See the "Exposure Draft Issued by the Auditing Standards Board" section of this Audit Risk Alert for further information.

## New Auditing Interpretations

.70 Auditing Interpretations are issued by the Audit Issues Task Force (AITF) of the ASB to provide timely guidance on the application of ASB pronouncements. Interpretations are reviewed by the ASB, but are not as authoritative as ASB pronouncements. Nevertheless, a departure from an Interpretation may have to be justified if the quality of a member's work is questioned. Interpretations become effective upon their publication in the *Journal of Accountancy*. A summary of recently issued Interpretations is presented below.

### *Interpretation No. 4 of AU Section 311, Planning and Supervision, "Audit Considerations for the Year 2000 Issue"*

.71 Issued in January 1998, this Interpretation provides guidance on three audit considerations relating to the year 2000 issue. The first addresses the auditor's responsibility regarding the year 2000 issue in an



audit of financial statements conducted in accordance with GAAS. The second discusses the impact of the year 2000 issue on planning for an audit of financial statements conducted in accordance with GAAS. Finally, the Interpretation discusses the auditor's responsibilities when, during the course of an audit, he or she becomes aware of a year 2000 issue that 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 in periods subsequent to the period under audit.

***Interpretation No. 1 of SAS No. 73, Using the Work of a Specialist, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125"***

.72 Issued in February 1998, Interpretation No. 1 of SAS No. 73, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial assets Qualifies as a Sale" (AICPA, *Professional Standards*, vol. 1, AU sec. 9336), provides guidance regarding the use of a legal specialist's findings as audit evidence to support management's assertion that a transfer of financial assets meets the legal isolation criterion of paragraph 9(a) of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Current Text*, vol. 1, sec. F38). The Interpretation addresses when the use of a legal specialist's work may be appropriate; factors that should be considered in assessing the adequacy of the legal response; and the use, as audit evidence, of legal responses that are restricted to the client's use. The Interpretation is effective for auditing procedures related to transactions required to be accounted for under FASB Statement No. 125 that were entered into on or after January 1, 1998. The AITF has amended the Interpretation to include the form of letter that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion as well as sample language that does not adequately communicate such permission. The amended Interpretation appeared in the October 1998 issue of the *Journal of Accountancy*.

***Interpretation No. 3 of SAS No. 70, Reports on the Processing of Transactions by Service Organizations, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls"***

.73 Issued in March 1998, this Interpretation provides guidance on the following:

- The type of information about controls at a service organization related to the year 2000 issue that would be considered relevant to user organizations and therefore should be included in a service organization's description of controls
- The service auditor's procedural and reporting responsibilities when relevant information about the year 2000 issue is included in or omitted from the service organization's description of controls
- Whether SAS No. 70 (AU sec. 324.32) requires a service auditor to identify in his or her report, design deficiencies that do not affect processing during the period covered by the service auditor's examination, but may represent potential year 2000 problems
- Whether a service organization may include in its description of controls, information about its plans to modify its systems to address the year 2000 issue
- The service auditor's procedural and reporting responsibilities if a service organization includes information or a control objective in its description of controls that addresses its plans to modify its systems in response to the year 2000 issue
- Whether a service auditor's report may be expanded to describe the risk of projecting conclusions to future periods because of a failure to make needed changes, such as changes to address the year 2000 issue

***Interpretation No. 2 of SAS No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"***

.74 Issued in July 1998, the Interpretation provides guidance to auditors regarding the identification and evaluation of conditions and events of the type identified in SAS No. 59 that relate to the year 2000 issue. The Interpretation states that the year 2000 issue can cause conditions or events of the type identified in of SAS No. 59 (AU sec. 341.03a). It also incorporates the concept underlying the Interpretation of AU section 311, *Planning and Supervision*, that the year 2000 issue does not create additional responsibilities for the auditor. Thus, in terms of SAS No. 59, the auditor does not have a responsibility to plan and perform procedures solely to identify conditions and events relating to the year 2000 issue. Rather, the auditing procedures performed in planning, gathering evidential matter, and completing the audit are sufficient for that purpose. In addition, the Interpretation—

- Provides guidance on the auditor's responsibilities if conditions or events relating to the year 2000 issue come to his or her attention.
- Highlights management's responsibility for assessing the effects of the year 2000 issue and developing an effective year 2000 remediation plan.
- Provides guidance on using a specialist in considering management's remediation plans.
- Includes a list of matters about which the auditor might consider obtaining management representations to complement other auditing procedures. (An auditor would consider obtaining those representations only if he or she identified conditions and events relating to the year 2000 issue and considered management's plans in accordance with of SAS No. 59 (AU sec. 341.07-.09).

***Interpretation No. 4 of SAS No. 31, Evidential Matter, "Applying Auditing Procedures to Segment Disclosures in Financial Statements"***

.75 Issued in August 1998, the Interpretation replaces rescinded SAS No. 21 by providing guidance for audits of financial statements of entities that have implemented FASB Statement No. 131. The Interpretation suggests procedures that auditors should consider in (1) planning the audit, (2) evaluating whether an entity has appropriately identified its reportable operating segments in accordance with FASB Statement No. 131, and (3) evaluating the adequacy and completeness of management's disclosures about reportable operating segments and related information, including products and services, geographic areas, and major customers. The Interpretation also includes reporting guidance.

***Interpretation No. 3 of SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties, "Commenting in a Comfort Letter on Quantitative and Qualitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K"***

.76 Interpretation No. 3 of SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9634), as amended by SAS No. 86 (AICPA, *Professional Standards*, vol. 1, AU sec. 634), is entitled "Commenting in a Comfort Letter on Quantitative and Qualitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K" was issued in August 1998. This Interpretation provides guidance on whether an accountant may provide positive or negative assurance on conformity with Item 305 of Regulation S-K and whether an accountant may otherwise provide comments in a comfort letter on items disclosed by registrants in accordance with Item 305 of Regulation S-K.

## New Attestation Interpretation

### ***Interpretation No. 1 of SSAE No. 8, Management's Discussion and Analysis, "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis"***

.77 Issued in August 1998, the Interpretation provides guidance on the practitioner's responsibility with respect to year 2000 disclosures in MD&A, such as those required by Staff Legal Bulletin No. 5 issued by the SEC's Divisions of Corporation Finance and Investment Management; how the practitioner might test year 2000 disclosures in MD&A, including using the work of a specialist; how the practitioner's approach to testing year 2000 disclosures would differ if a review rather than an examination engagement is performed; and what written management representations concerning year 2000 disclosures the practitioner might obtain to supplement other procedures.

## New Audit Issues Task Force Advisories<sup>5</sup>

.78 ***AITF Advisory Concerning Comprehensive Income.*** In June 1997, the FASB issued Statement No. 130, *Reporting Comprehensive Income* (FASB, *Current Text*, vol. 1, sec. C49). The Statement, which is effective for fiscal years beginning after December 15, 1997, establishes standards for the reporting and display of comprehensive income and its components in a full set of general-purpose financial statements, including interim-period reporting. FASB Statement No. 130 requires that comprehensive income and its components be reported in a financial statement that is displayed with the same prominence as other financial statements. Although it does not require a specific format, the Statement provides illustrations that display comprehensive income and its components in a separate statement, as an add-on to the statement of income, or integrated with the statement of changes in equity. The AITF is advising auditors as follows.

- The introductory paragraph of the auditor's report should specifically identify each financial statement audited. The adoption of FASB Statement No. 130 would require either adding a reference for a separate statement of comprehensive income, if presented, or reflecting a modified financial statement title.
- Adoption of FASB Statement No. 130 does not affect the opinion paragraph of the auditor's report because comprehensive income is part of the presentation of financial position, results of operations, and cash flows.

Because adoption of FASB Statement No. 130 only involves reclassification of prior-period information presented for comparative purposes, it is not an accounting change that affects consistency. Accordingly, an explanatory paragraph about the statement's effects is not required to be included in the auditor's report on financial statements.

### ***AITF Advisory—Concerning Practice Issues Regarding Language to Permit the Use of Legal Opinions by Auditors***

.79 Note that the guidance in this AITF Advisory has been incorporated into an amendment of the interpretation that appeared in the October *Journal of Accountancy*. See the "New Auditing Interpretations" section of this Audit Risk Alert. In December 1997, the AITF issued an Interpretation of SAS No. 73, *Using the Work of a Specialist*, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of FASB Statement No. 125." Paragraph 16 of the Interpretation notes that if a legal letter restricts use of the findings expressed therein to the client or to third parties other than the auditor, then the auditor should request that the client obtain the legal specialist's written permission for the auditor to use the opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 125.

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<sup>5</sup> From time to time the AITF issues, AITF Advisories to provide nonauthoritative guidance on current developments or recently issued authoritative literature.

.80 The AITF has been made aware that some legal letters addressed to clients authorize the client to make copies of the legal opinion available to auditors to use in their evaluation of management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 125, but then state that the auditor is not authorized to rely thereon. The AITF is advising auditors that, effective with the publication of this Advisory, such "use but not rely on" language, or other language that similarly restricts the auditor's use of the legal specialist's opinion, should not be used as audit evidence. The auditor may wish to consult with his or her legal counsel concerning circumstances in which it is not clear that the auditor may use the legal specialist's opinion.

#### **Executive Summary—New Auditing and Attestation Pronouncements**

New Auditing Standards include the following:

- SAS No. 86, *Amendment to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties*
- SAS No. 87, *Restricting the Use of an Auditor's Report*
- Rescission of SAS No. 21, *Segment Information*

ASB Pronouncements with effective dates in 1998 are the following:

- SAS No. 83, *Establishing an Understanding With the Client*
- SAS No. 84, *Communications Between Predecessor and Successor Auditors*
- SAS No. 85, *Management Representations*
- SSAE No. 7, *Establishing an Understanding With the Client*

The new Attestation Standard is SSAE No. 8, *Management's Discussion and Analysis*. Also, in September 1998, the ASB voted to issue the exposure draft *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity's Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation* as a final standard. See the "Exposure Draft Issued by the Auditing Standards Board " section of this Audit Risk Alert for further information.

New Auditing Interpretations include the following:

- Interpretation No. 14 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), "Evaluating the Adequacy of Disclosure in Financial Statements prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting" (AICPA, *Professional Standards*, vol. 1, AU sec. 9623) (discussed in *Audit Risk Alert—1997/98*)
- Interpretation No. 4 of AU Section 311, *Planning and Supervision*, "Audit Considerations for the Year 2000 Issue"
- Interpretation No. 1 of SAS No. 73, *Using the Work of a Specialist*, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125"
- Interpretation No. 3 of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls"
- Interpretation No. 2 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"
- Interpretation No. 4 of SAS No. 31, *Evidential Matter*, "Applying Auditing Procedures to Segment Disclosures in Financial Statements"
- Interpretation No. 3 of SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties*, "Commenting in a Comfort Letter on Quantitative and Qualitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K"

The new Attestation Interpretation is Interpretation No. 1 of SSAE No. 8, *Management's Discussion and Analysis*, "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis."

The new AITF Advisories address the following:

- Reporting comprehensive income
- Practice Issues regarding language to permit the use of legal opinions by auditors (Note that this Advisory was an intermediary document. It was replaced by the amended Interpretation that appears in the "New Auditing Interpretations" section of this Audit Risk Alert.)

New ASB Statements of Position (SOP) are the following:

- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
- SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Marketplace Standards Association*
- SOP 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission*

Summaries of these SOPs are presented in the New AICPA Statements of Position section of this Audit Risk Alert.

## Recent GAAP Pronouncements

*What new accounting pronouncements have been issued this year?*

### New FASB Pronouncements

#### ***FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits, an Amendment of FASB Statements No. 87, 88, and 106***

.81 In February 1998, the FASB issued Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (FASB, *Current Text*, vol. 1, secs. P16 and P40)

.82 FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statements No. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16), No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, sec. P16), and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40), were issued. FASB Statement No. 132 suggests combined formats for presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

.83 FASB Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

**FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities**

.84 In June 1998, the FASB issued FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50). FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (2) a hedge of the exposure to variable cash flows of a forecasted transaction, or (3) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.85 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.86 For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a *fair value hedge*), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

.87 For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a *cash flow hedge*), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

.88 For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair value hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.

.89 For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.90 Under FASB Statement No. 133, an entity that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

.91 FASB Statement No. 133 applies to all entities. A not-for-profit organization should recognize the change in fair value of all derivatives as a change in net assets in the period of change. In a fair value hedge, the changes in the fair value of the hedged item attributable to the risk being hedged also are recognized. However, because of the format of their statement of financial performance, not-for-profit organizations are not permitted special hedge accounting for derivatives used to hedge forecasted transactions. FASB Statement No. 133 does not address how a not-for-profit organization should determine the components of an operating measure if one is presented.

.92 FASB Statement No. 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction except that a nonderivative instru-

ment denominated in a foreign currency may be designated as a hedge of the foreign currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

.93 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It supersedes FASB Statements No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. FASB Statement No. 133 also nullifies or modifies the consensus reached in a number of issues addressed by the EITF.

.94 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

.95 FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB Statement No. 65 (issued October, 1998).

### **FASB Technical Bulletin No. 97-1**

.96 FASB Technical Bulletin No. 97-1, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*, provides guidance on accounting for certain employee stock purchase plans under FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FASB, *Current Text*, vol. 1, sec. C36). The bulletin does not address the accounting for those plans under APB Opinion 25, *Accounting for Stock Issued to Employees* (FASB, *Current Text*, vol. 1, sec. C47). The Bulletin applies to stock-based awards granted, renewed, or modified on or after January 1, 1998.

#### **Executive Summary—New FASB Pronouncements**

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of FASB Statement Nos. 87, 88, and 106
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB Statement No. 65 (issued October, 1998)
- FASB Technical Bulletin No. 97-1, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*

### **New AICPA Statements of Position**

#### **Statement of Position 97-2, Software Revenue Recognition**

.97 Issued in October 1997 by the Accounting Standards Executive Committee (AcSEC), SOP 97-2, *Software Revenue Recognition*, supersedes SOP 91-1, *Software Revenue Recognition*, and is effective for transactions entered into in fiscal years beginning after December 15, 1997.

.98 The SOP provides guidance on applying GAAP in recognizing revenue on software transactions, and includes the following in its requirements:

- 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 ARB No. 45, *Long-Term Construction-Type Contracts* (FASB, *Current Text*, vol. 2, sec. Co4), 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.
- Separate accounting for a service element of an arrangement to which contract accounting applies is required if both of the following criteria are met.
  1. The services are not essential to the functionality of any other element of the transaction.
  2. 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.
- 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.
  1. Persuasive evidence of an agreement exists.
  2. Delivery has occurred.
  3. The vendor's fee is fixed or determinable.
  4. Collectibility is probable.
- Software arrangements may consist of multiple elements, that is, additional software products, upgrades or enhancements, 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 (VSOE) of fair values. If sufficient VSOE 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, services that do not involve significant customization, subscriptions, and arrangements in which the fee is based on the number of copies. VSOE of fair value is limited to (1) the price charged when the element is sold separately, or (2) if not yet being sold separately, the price for each element established by management having the relevant authority.
- 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.

### **SOP 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments**

.99 In December 1997, AcSEC issued SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*. This SOP applies to all entities, not just insurance enterprises, subject to insurance-related assessments, including self-insurers and participants in second injury funds.

.100 This SOP addresses the accounting by insurance and other enterprises for assessments related to insurance activities. The SOP provides the following:

- Guidance for determining when an entity should recognize a liability for guaranty-fund and other insurance-related assessments



- Guidance on how to measure the liability (It allows for the discounting of the liability if the amount and timing of the cash payments are fixed or reliably determinable.)
- Guidance on 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

.101 SOP 97-3 is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged; retroactive application is prohibited. Initial application of this SOP should be as of the beginning of an entity's fiscal year (that is, should an entity adopt the SOP prior to the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Entities subject to insurance-related assessments should report the effect of initially adopting this SOP in a manner similar to the reporting of a cumulative effect of a change in accounting principle.

### **SOP 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use**

.102 In March 1998, AcSEC issued SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. This SOP provides guidance on accounting for the costs of computer software developed or obtained for internal use. It requires the following.

- Computer software costs that are incurred in the preliminary project stage should be expensed as incurred. Once the capitalization criteria of the SOP have been met, external direct costs of materials and services consumed in developing or obtaining internal-use computer software; payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and interest costs incurred when developing computer software for internal use should be capitalized. Training costs and many kinds of data conversion costs should be expensed as incurred.
- Internal costs incurred for upgrades and enhancements that add functionality should be expensed or capitalized using the same criteria as for new software. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.
- External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized using the same criteria as for new software. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.
- Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08).
- The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.
- If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, should be applied against the carrying amount of that software.

SOP 98-1 identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use. The SOP applies to all nongovernmental entities and is effective

for financial statements for fiscal years beginning after December 15, 1998. It should be applied to internal-use software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of the SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Costs incurred prior to initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred.

### **SOP 98-2, Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising**

.103 In March 1998, AcSEC issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*. It applies to all nongovernmental not-for-profit organizations (NPOs) and all state and local governmental entities that solicit contributions. This SOP requires the following:

- If the criteria of purpose, audience, and content as defined in this SOP are met, the costs of joint activities that are identifiable with a particular function should be charged to that function, and joint costs should be allocated between fund raising and the appropriate program or management and general function.
- If any of the criteria of purpose, audience, and content are not met, all costs of the activity should be reported as fund-raising costs, including costs that otherwise might be considered program or management and general costs if they had been incurred in a different activity, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions that are part of joint activities, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising.
- Certain financial statement disclosures must be made if joint costs are allocated.

The SOP also describes and illustrates some commonly used and acceptable allocation methods although no methods are prescribed or prohibited. This SOP amends existing guidance in AICPA Audit and Accounting Guides *Health Care Organizations* and *Not-for-Profit Organizations* (which was issued in August 1996 and supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, because the provisions of SOP 87-2 are incorporated into the Guide), and *Audits of State and Local Governmental Units*.

.104 This SOP is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

### **SOP 98-3, Audits of States, Local Governments, and Not-For-Profit Organizations Receiving Federal Awards**

.105 In March 1998, SOP 98-3, *Audits of States, Local Governments, and Not-For-Profit Organizations Receiving Federal Awards*, was issued under the authority of the ASB. This SOP provides guidance on conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and the June 1997 revision to OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. It supersedes SOP 92-9, *Audits of Not-For-Profit Organizations Receiving Federal Awards*, and Part VII of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*. In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, the SOP describes the auditor's responsibility for considering internal control and performing tests of compliance with applicable laws, regulations, and program compliance requirements under GAAS, *Government Auditing Standards*, and OMB Circular A-133; and describes the auditor's responsibility for reporting and provides examples of the reports required by *Government Auditing Standards* and OMB Circular A-133.

.106 The requirements of the Single Audit Act and OMB Circular A-133 are effective for audits of fiscal years beginning after June 30, 1996. This SOP also includes auditing guidance through AICPA SAS No. 85, *Management Representations*. The effective dates of this auditing guidance should be applied as provided for in the related literature. This SOP does not change the effective dates of the auditing standards, the Act, and OMB Circular A-133. The remaining provisions of this SOP are applicable to audits of fiscal years beginning after June 30, 1996, in which the related fieldwork commences on or after March 1, 1998. Earlier application is encouraged.

#### **SOP 98-4, Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition**

.107 In March 1998, AcSEC issued SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*. This SOP defers for one year the application of the following passages in SOP 97-2, which limit what is considered VSOE of the fair value of the various elements in a multiple-element arrangement:

1. The second sentences of paragraphs 10, 37, 41, and 57
2. Example 3 in "Multiple-Element Arrangements—Products" on page 67 (appendix A)
3. Example 3 in "Multiple-Element Arrangement—Products and Services" on page 70 (appendix A)

All other provisions of SOP 97-2 remain in effect.

.108 This SOP applies to all multiple-element software arrangements, as defined in paragraph 9 of SOP 97-2, and is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated.

#### **SOP 98-5, Reporting on the Costs of Start-Up Activities**

.109 In April 1998, AcSEC issued SOP 98-5, *Reporting on the Costs of Start-Up Activities*. This SOP provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred.

.110 The SOP broadly defines start-up activities and provides examples to help entities determine what costs are and are not within the scope of this SOP. This SOP applies to all nongovernmental entities and, except for certain investment companies, is effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements previously have not been issued. Except for certain entities noted in the following paragraph, initial application of this SOP should be reported as the cumulative effect of a change in accounting principle, as described in APB Opinion 20, *Accounting Changes*. When adopting this SOP, entities are not required to report the pro forma effects of retroactive application. Entities that report substantially all investments at market value or fair value, issue and redeem shares, units, or ownership interests at net asset value, and have sold their shares, units, or ownership interests to independent third parties before the later of June 30, 1998, or the date that the SOP is issued should adopt the SOP prospectively.

#### **SOP 98-6, Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association**

.111 In April 1998, SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*, was issued under the authority of the ASB. This SOP pertains to the sales and marketing policies and procedures of life insurance entities. The SOP provides guidance to practitioners in conducting and reporting on an independent examination of management's assertion about those policies and procedures performed under SSAE No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100), to assist an entity in meeting the requirements

of the Insurance Marketplace Standards Association (IMSA) program. IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its Assessment Handbook and requirements.

.112 This SOP amends chapter 9, "Auditors 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*.

### **SOP 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk**

.113 In November 1998, AcSEC will issue SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*. The SOP will address deposit accounting for certain insurance and reinsurance contracts and direct business by insurance enterprises and other enterprises. SOP 98-7 will provide guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in the SOP as deposit accounting. SOP 98-7 does not address when deposit accounting should be applied.

.114 The SOP specifies the following.

1. Insurance and reinsurance contracts for which the deposit method is appropriate should be classified as one of the following, which are those—
  - That transfer only significant timing risk.
  - That transfer neither significant timing nor underwriting risk.
  - With indeterminate risk.
2. At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.

The SOP would adopt the interest method as described in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FASB, *Current Text*, vol. 1, sec L10), for insurance and reinsurance contracts that transfer only significant timing risk and insurance and reinsurance contracts that transfer neither significant timing nor underwriting risk.

.115 Insurance and reinsurance contracts that transfer only significant underwriting risk would be accounted for by measuring the deposit based on the unexpired portion of the coverage provided until losses are incurred that will be reimbursed under the contract. Once a loss is incurred that will be reimbursed under the contract, the deposit would be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided. Changes in the recorded amount of the deposit, other than the expired portion of the coverage provided, would be included in the income statement of the insured as an offset to the loss that will be reimbursed under the contract.

.116 Insurance and reinsurance contracts with indeterminate risk, would be accounted for in a manner similar to the open-year method described in SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance*.

.117 SOP 98-7 is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Restatement of previously issued annual financial statements is not permitted. Initial application of this SOP is as of the beginning of an entity's fiscal year (that is, if the SOP were adopted before

the effective date and during an interim period, all prior interim periods are required to be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20, *Accounting Changes*).

**SOP 98-8, Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission**

.118 This SOP has been posted in its entirety on the AICPA Web site <http://www.aicpa.org>.

**Executive Summary—New AICPA Statements of Position**

- SOP 97-2, *Software Revenue Recognition*
- SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*
- SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
- SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*
- SOP 98-5, *Reporting on the Costs of Start-Up Activities*
- SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*
- 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance contracts That Do Not Transfer Insurance Risk*

*Note:* AcSEC's Proposed Statement of Position: *Modification of the Limitations on Evidence of Fair Value in Software Arrangements*, which would affect SOP Nos. 97-2 and 98-4 is expected to be issued as a final SOP before year end.

**EITF Consensus Positions**

.119 The Emerging Issues Task Force (EITF) was established by the FASB in July 1984 to assist in improving financial reporting through the timely identification, discussion, and resolution of financial issues within the framework of existing authoritative literature. The application of EITF consensus (category c of the GAAP hierarchy) effective after March 15, 1992 is mandatory under SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 411). EITF consensus issued before March 16, 1992 become effective in the hierarchy for initial application of an accounting principle after March 15, 1993. The EITF meets approximately every eight weeks. All meetings are announced by the FASB in its *Action Alert*, together with a listing of the topics on the meeting agenda.

EITF Issue No.	Description	Date of Consensus/Status
96-19	<i>Debtor's Accounting for a Substantive Modification and Exchange of Debt Instruments</i>	Implementation guidelines added July 23, 1998
97-2	<i>Application of APB 16 and SFAS 94 to Physician's Practice Entities</i>	Consensus reached November 20, 1997

(Continued)

<i>EITF Issue No.</i>	<i>Description</i>	<i>Date of Consensus/Status</i>
97-5	<i>Accounting for the Delayed Receipt of Option Shares Upon Exercise Under APB Opinion No. 25, Accounting for Stock Issued to Employee</i>	FASB Staff Announcement July 23-24, 1997
97-8	<i>Accounting for Contingent Consideration Issued in a Purchase Business Combination</i>	Consensus reached July, 1997
97-9	<i>Effect on Pooling-of-Interests Accounting of Certain Contingently Exercisable Options or Other Equity Instruments</i>	Consensus reached September 18, 1997
97-10	<i>The Effect of Lessee Involvement in Asset Construction</i>	Consensus reached May 21, 1998. (Changes made to consensus July 23, 1998)
97-11	<i>Accounting for Internal Costs Relating to Real Estate Property Acquisitions</i>	Consensus reached March 18, 1998
97-12	<i>Accounting for Increased Share Authorization in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25, Accounting for Stock Issued to Employees</i>	Consensus reached September 18, 1997
97-13	<i>Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation</i>	Consensus reached November 20, 1997
97-14	<i>Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested</i>	Consensus reached May 21, 1998; Consensus reached on transition July 23, 1998.
97-15	<i>Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination</i>	Consensus reached March 18-19, 1998
98-1	<i>Valuation of Debt Assumed in a Purchase Business Combination</i>	Consensus reached March 18-19, 1998
98-2	<i>Accounting by a Subsidiary for an Investment in Its Parent Company's Stock</i>	No consensus reached. Further discussion expected.
98-3	<i>Determining Whether a Transaction Is an Exchange of Similar Productive Assets or a Business Combination</i>	Further discussion planned March 18-19, 1998.
98-4	<i>Accounting by a Joint Venture for Businesses Received at Its Formation</i>	Further discussion planned March 18-19, 1998.
98-5	<i>Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios</i>	September 23-24, 1998 discussed but not asked to reach a consensus. Further discussion planned.
98-6	<i>Investor's Accounting For an Investment in a Limited Partnership Investment When The Investor Is The General Partner And The Limited Partners Have Certain Approval Or Veto Rights</i>	September 23-24, 1998. Further discussion planned.

<i>EITF Issue No.</i>	<i>Description</i>	<i>Date of Consensus/Status</i>
98-7	<i>Accounting for Exchanges of Similar Equity Method Investments</i>	Consensus reached May 21, 1998.
98-8	<i>Accounting for Transfers of Investments that Are in Substance Real Estate</i>	Consensus reached May 21, 1998.
98-9	<i>Accounting for Contingent Rent in Interim Financial Periods</i>	September 23-24, 1998. Prior consensus on lessee accounting withdrawn, new consensus reached. Further discussion planned.
98-10	<i>Accounting for Energy Trading and Risk Management Activities</i>	September 23-24, 1998. Further discussion planned.
98-11	<i>Accounting For Acquired Temporary Differences In Certain Purchase Transactions That Are Not Accounted For As Business Combinations</i>	Consensus reached on one issue September 23, 1998. Further discussion planned.
98-12	<i>Application of EITF Issue No. 96-13, "Accounting For Derivative Financial Instruments Indexed To, And Potentially Settled In, A Company's Own Stock, To Certain Derivative Financial Instruments Issued With Other Instruments."</i>	September 23-24, 1998. Further discussion planned.
98-13	<i>Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee</i>	September 23-24, 1998. Further discussion planned.
98-14	<i>Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements</i>	September 23-24, 1998. Further discussion planned.

## Exposure Draft Issued by the Auditing Standards Board

.120 In June 1998, the ASB issued an exposure draft of a proposed SSAE entitled: *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity's Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation*. This proposed SSAE would—

- Enable a practitioner to directly report on specified subject matter, such as an entity's internal control over financial reporting, rather than on management's assertion about the internal control. In either case, the practitioner would continue to be required to obtain management's assertion as condition of engagement performance.
- Eliminate, in certain cases, the requirement for a separate presentation of management's assertion if the assertion is included in the introductory paragraph of the practitioner's report.
- Revise the reporting guidance on the SSAEs so that SSAE reports would contain elements that are similar to those included in auditors' reports on historical financial statements, as prescribed in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508).
- Provide guidance on the relationship between the SSAEs and the Statements on Quality Control Standards.

In September 1998, the ASB voted to issue this exposure draft as a final standard.

## Guides and Audit Risk Alerts

### AICPA Audit and Accounting Guides

.121 The 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 (product numbers are shown in parentheses):

- Agricultural Producers and Cooperatives (012353)
- Airlines (013182)
- Banks and Savings Institutions (011177)
- Brokers and Dealers in Securities (012180)
- Casinos (013149)
- Colleges and Universities<sup>6</sup> (013323)
- Common Interest Realty Associations (012487)
- Construction Contractors (012095)
- Credit Unions (012058)
- Employee Benefit Plans (012338)
- Entities With Oil and Gas Producing Activities (012105)
- Federal Government Contractors (012437)
- Finance Companies (012465)
- Health Care Organizations (012438)
- Investment Companies (012362)
- Not-for-Profit Organizations (013391)
- Property and Liability Insurance Companies (011921)
- State and Local Governmental Units (012057)
- Voluntary Health and Welfare Organizations<sup>6</sup> (012158)

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 (012451)
- Personal Financial Statements (011135)
- Prospective Financial Information (012067)
- Use of Real Estate Appraisal Information (013159)

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<sup>6</sup> Use of this Guide is limited to certain governmental units accounted for under Statements on Governmental Accounting Standards (SGAS) Nos. 15 and 29.



## AICPA Annual Industry Audit Risk Alerts

.122 The AICPA's annual Risk Alerts series provides information about current economic, regulatory, and professional developments in specified industries and practice areas. They assist CPAs in planning and performing such engagements. 1998/99 Audit Risk Alerts are available from the AICPA for the following industries (product numbers are shown in parentheses):

- Auto Dealerships [AAM section 8160]
- Compilation and Review [AAM section 8015]
- Construction Contractors [AAM section 8120]
- Common Interest Realty Associations [AAM section 8100]
- Depository and Lending Institutions [AAM section 8050]
- Employee Benefit Plans [AAM section 8060]
- Health Care [AAM section 8030]
- HighTechnology [AAM section 8200]
- Insurance [AAM section 8040]
- Investment Companies [AAM section 8150]
- NotforProfit 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]

## Other Accounting and Auditing Team Publications

.123 *Audit and Accounting Manual (Product Number 007258)*. The manual is designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations—including audit programs and sample letters.

.124 *AICPA Practice Aid Series*. The publications that constitute the AICPA Practice Aid Series have been designed to address a broad range of topics that affect today's CPA. From enhancing the efficiency of your practice to developing the new skill sets required for a successful transition to meet the challenges of the new millennium, this series provides practical guidance and information to assist in making sense out of a changing and complex business environment. The series includes the following:

- Preparing and Reporting on Cash- and Tax-Basis Financial Statements (Product Number 006701)
- Financial Statement Reporting and Disclosure Practices for Employee Benefit Plans (Product Number 008725)
- Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133 Audits of States, Local Governments, and Non-Profit Organizations June 1997 revisions (Product Number 008730)
- Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82 (Product Number 008883)

- Auditing Estimates and Other Soft Accounting Information (Product Number 010010)
- Make Audits Pay—Leveraging the Audit into Consulting Services (Available beginning in early 1999)
- CPA ElderCare: A Practitioner's Resource Guide (Product Number 022504)
- Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools (Product Number 006600)

**.125 *Financial Statement Preparation Manual/Disclosure Checklists (Product Number G01027).*** The manual is a loose-leaf service of nineteen disclosure checklists and sample financial statements for various industries that is updated to reflect the issuance of new authoritative guidance. The checklists are the individual paperback versions that are generated from the loose-leaf and published annually.

**.126 *Accounting Trends and Techniques—1998 (Product Number 009890).*** Highlights the latest trends in corporate financial statements are presented for practitioners in industry and public practice. The publication, which is based on a survey of over 600 public companies, illustrates accounting practices and trends, including presentations and disclosures.

## AICPA Services

### Order Department

**.127** To order AICPA products, call (888) 777-7077; 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. Obtaining product information and placing online orders can be done at the AICPA's Web site <http://www.aicpa.org>.

### Accounting and Auditing Technical Hotline

**.128** The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

### Ethics Hotline

**.129** Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

### World Wide Web Site

**.130** The AICPA has 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. The Web site includes *In Our Opinion*, the newsletter of the AICPA Audit and Attest Standards Team. The newsletter provides valuable and timely information on technical activities and developments in auditing and attestation standard setting.

**.131** This Audit Risk Alert replaces *Audit Risk Alert—1997/98*.

**.132** Practitioners Publishing Company (PPC) and the AICPA currently offer a 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*, and *Peer Review Program Manual*. 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

**.133** The Audit Risk Alert is published annually. As you encounter audit issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share those with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may email these comments to [GDietz@aicpa.org](mailto:GDietz@aicpa.org) or write to:

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.134

## Appendix

### The Internet—An Auditor's Research Tool

Some Web sites that may provide valuable information to auditors are listed in the following table:

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	<a href="http://www.aicpa.org">http://www.aicpa.org</a>
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	<a href="http://www.fasb.org">http://www.fasb.org</a>
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	<a href="http://www.gasb.org">http://www.gasb.org</a>
General Accounting Office	GAO policy and guidance materials, reports on federal agency major rules.	<a href="http://www.gao.gov">http://www.gao.gov</a>
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	<a href="http://www.electronicaccountant.com">http://www.electronicaccountant.com</a>
AuditNet	Electronic communications among audit professionals	<a href="http://www.cowan.edu.au/mra/home.htm">http://www.cowan.edu.au/mra/home.htm</a>
CPAnet	Links to other Web sites of interest to CPAs	<a href="http://www.cpalinks.com/">http://www.cpalinks.com/</a>
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	<a href="http://www.tetranet.net/users/gaostl/guide.htm">http://www.tetranet.net/users/gaostl/guide.htm</a>
Accountant's Home Page	Resources for accountants and financial and business professionals	<a href="http://www.computercpa.com/">http://www.computercpa.com/</a>
Double Entries	A weekly newsletter on accounting and auditing around the world	<a href="http://www.csu.edu.au/lists.anet/ADBLE-L/index.html">http://www.csu.edu.au/lists.anet/ADBLE-L/index.html</a>
U.S. Tax Code Online	A complete text of the U.S. Tax Code	<a href="http://www.fourmilab.ch/ustax/ustax.html">http://www.fourmilab.ch/ustax/ustax.html</a>
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory.	<a href="http://www.fsforum.com">http://www.fsforum.com</a>

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Cybersolve	Online financial calculators such as ratio and breakeven analysis	<a href="http://www.cybersolve.com/tools1.html">http://www.cybersolve.com/tools1.html</a>
FedWorld. Gov	U.S. Department of Commerce sponsored site providing access to government publications	<a href="http://www.fedworld.com">http://www.fedworld.com</a>
Hoovers Online	Online information on various companies and industries	<a href="http://www.hoovers.com">http://www.hoovers.com</a>
Vision Project	Information on the profession's vision project	<a href="http://www.cpavision.org/horizon">http://www.cpavision.org/horizon</a>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.kentis.com/ib.html">http://www.kentis.com/ib.html</a>

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# AAM Section 8015

## *Compilation and Review Alert—1998/99*

### NOTICE TO READERS

This Compilation and Review Alert is intended to provide CPAs with an update on recent practice issues and professional standards that affect compilation and review engagements. This document has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

### In This Year's Alert . . .

- What's the authority of the *Compilation and Review Alert—1998/99*?
- What's the current status of the Accounting and Review Services Committee's deliberations on how to clarify the applicability of SSARS No. 1?
- What are the performance standards in a compilation engagement? Is it permissible for paraprofessionals to perform the compilation engagement and to issue the report?
- Can a CPA be required to compile financial statements if he or she was not engaged to do so? When is a review required?
- What working papers are required for a compilation engagement? What working papers are required for a review engagement?
- Are successor accountants required to obtain the working papers of predecessor accountants who compiled, reviewed, or audited the financial statements of the prior year?
- If the prior year's financial statements are audited by a predecessor accountant and the successor accountant proposes to perform a review or compilation under SSARS No. 1, is the successor accountant obligated to communicate with the predecessor?
- What guidance is available to assist with reporting on comparative financial statements when a change of accountants or a change in the level of service has occurred?
- When SSARS No. 1 refers to "knowledge acquired in performing other accounting services," what does the phrase "may result in modification" mean?
- What kinds of analytical procedures does the accountant perform and how should they be applied?
- When should an accountant add a paragraph to a compilation or review report to emphasize a matter about the financial statements?
- Are accountants performing compilation and review engagements required to resolve complex technical and ethical questions through consultation? If consultation is used, should the working papers document the question and conclusion reached?
- Does SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, apply to compilation and review engagements?

- Does ARSC plan to revise the illustrative review representation letter presented in appendix D of SSARS No. 1 to reflect the issuance of SAS No. 85?
- What responsibility do accountants have for the year 2000 issue in compilation and review engagements? What year 2000 issue accounting guidance is available to help accountants follow GAAP in compiled or reviewed financial statements?
- Are accountants required to consider GAAP disclosures in reporting on compiled or reviewed cash- and income tax-basis financial statements?
- What publications are included in the hierarchy of “must-know” GAAP for accountants performing compilations and reviews?
- What new GAAP pronouncements have been published since October 1997 (publication of last year’s *Compilation and Review Alert*)?
- How do I obtain AICPA publications related to compilation and review practice?
- What is the best CPE course for getting a basic understanding of SSARS Nos. 1 to 7 or introducing new staff accountants and paraprofessionals to those standards?

\* \* \* \*

## Introduction

### *What’s the authority of the Compilation and Review Alert—1998/99?*

.01 The *Compilation and Review Alert—1998/99* is a nonauthoritative practice aid designed to help accountants plan and perform their 1998 and 1999 compilation and review engagements. It clarifies certain existing Statements on Standards for Accounting and Review Services (SSARSs), suggests ways of implementing those standards in special circumstances, points out pitfalls that frequently occur in compilation and review engagements, and addresses emerging practice problems.

## Current Issues

### Developments at the ARSC

#### *What’s the current status of the Accounting and Review Services Committee’s deliberations on how to clarify the applicability of SSARS No. 1?*

.02 Since 1994, the Accounting and Review Services Committee (ARSC) has been trying to clarify the applicability of SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), and to make sure that the existing standards square with developments in technology and regulation. To understand where ARSC is today, the following is a summary of the major developments in the history of this project.

- September 1995—ARSC issues an exposure draft of a proposed SSARS entitled “Assembly of Financial Statements for Internal-Use Only” that would have permitted CPAs to prepare financial statements for clients without having to compile them.
- February and May 1996—ARSC meets to discuss the more than 500 comment letters received on the exposure draft and seeks additional information about the kinds of problems CPAs encounter when performing compilation engagements.
- August 1997—After extensive discussion and fact-finding, ARSC conducts a two-day public hearing to solicit views on (1) the applicability of SSARS, (2) additional exemptions from SSARS, and (3) the



acceptability of plain-paper financial statements (meaning, statements that do not disclose the identity of the CPA who has prepared them). Nineteen speakers participated in the public hearing. There were divergent views on the first two issues listed above; seventeen of the nineteen participants were opposed to plain-paper financial statements.

- October 1997—ARSC meets to discuss the public hearing, votes to withdraw the assembly exposure draft, and concludes that plain-paper financial statements should not be permitted.
- February 1998—ARSC concludes that along with a major educational effort, the practice problems emanating from SSARS No. 1 can be best remedied by three exposure drafts that (1) clarify the applicability of SSARS, (2) preclude a CPA from compiling financial statements for a client if the CPA performs controllership services for that client, and (3) exempt financial statements included in written business valuations from the applicability of SSARS.
- July 1998—ARSC discusses the effect of recent rules enacted by the Florida Legislature to comply with a federal court ruling decreeing that CPAs employed by unlicensed firms (firms such as American Express Tax and Business Services that are not CPA firms) be permitted to hold out as CPAs and be associated with financial statements. The Florida rules enable CPAs working for such firms to be associated with financial statements of their clients. However, Florida rules and the AICPA Bylaws prohibit CPAs in unlicensed firms from compiling financial statements in accordance with the SSARS. The dilemma can best be summarized as follows.
  1. According to the Florida rules, CPAs in nontraditional firms can report on financial statements that they issue to clients or others via an assembly service.
  2. Such CPAs cannot compile or report on those financial statements in accordance with the SSARS.
  3. CPAs who issue financial statements to clients or others outside of SSARS, as permitted in item 1 in the preceding, are in violation of AICPA rules.

No matter what, something has to change. Because of the complexity and far-reaching consequences of the issues, the ARSC voted to hold in abeyance the three exposure drafts discussed above. Currently, the AICPA Board of Directors is considering alternative solutions to the problem—stay tuned.

## The Compilation—A Professional Service

*What are the performance standards in a compilation engagement? Is it permissible for paraprofessionals to perform the compilation engagement and issue the report?*

.03 A compilation involves more than merely reading the client's financial statements and attaching a compilation report to those financial statements. And although a compilation report provides no assurance that the financial statements are in conformity with generally accepted accounting principles (GAAP) or another comprehensive basis of accounting (OCBOA), there are performance requirements that must be followed. As a refresher, the following is a summary of the compilation performance requirements. The accountant should do the following.

1. Establish an understanding with the entity about the services to be performed and the report the accountant expects to issue.
2. Have or obtain knowledge of the accounting principles and practices of the entity's industry (GAAP or OCBOA) and a general understanding of the following:
  - a. Nature of the entity's transactions
  - b. Form of its accounting records
  - c. Stated qualifications of its accounting personnel
  - d. Accounting basis on which the financial statements are to be presented and the form and content of those financial statements

3. Consider whether it is necessary to perform other accounting services before compiling the financial statements.
4. Perform additional work if information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.
5. Read the compiled financial statements and consider whether they appear to be appropriate in form and free from obvious material error.

In general, a compilation requires an informal reading of the client's financial statements to determine whether they are in proper form (GAAP or OCBOA) and whether they contain obvious material errors. A staff person or a paraprofessional may perform the compilation, prepare the accountant's report, and submit them to a client provided that they meet the aforementioned performance requirements and provided that the CPA firm retains responsibility for the engagement and the representations in the compilation report. Of course, this would entail appropriate supervision and review of the staff person or paraprofessional performing the compilation procedures. The extent of the supervision and review would vary depending on the experience and knowledge of the person performing the work. Finally, accountants should remember that a compilation is a professional service and, although it is not an assurance engagement, they should always follow the performance and reporting standards in the SSARSs.

### Required Compilations, Required Reviews

*Can a CPA be required to compile financial statements if he or she was not engaged to do so? When is review required?*

#### Required Compilations

.04 The accountant must perform a compilation whenever all of the following conditions are met.

1. Financial statements, including a single financial statement such as a balance sheet or a statement of cash receipts and disbursements are presented.
2. The financial statements are not audited or reviewed.
3. The client is a nonpublic entity, for example, a corporation, a combined group of affiliated entities, a not-for-profit organization, a governmental unit, an estate or trust, a partnership, a proprietorship, a segment of any of these, or an individual.
4. The accountant submits the financial statements to clients or anyone else.

.05 There are four specific exemptions from the general compilation performance and reporting standards. These are as follows:

1. *Certain personal financial statements.* See SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans*, (AICPA, *Professional Standards*, vol. 2, AR sec. 600).
2. *Tax returns, including Forms 990 for organizations exempt from income tax, and 5500 for employee benefit plans.* See Interpretation No. 10, "Reporting on Tax Returns," of SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.31 and .32).
3. *Certain prescribed forms when designed by the user, not the client.* See SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300).
4. *Certain litigation support services that involve pending or potential formal legal or regulatory proceedings before a trier of fact.* See Interpretation No. 20, "Applicability of Statements on Standards for Accounting and Review Services to Litigation Services," of SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.76-.78).

Notably absent from the preceding exemptions are financial statements included in consulting engagements and so-called plain paper financial statements that are printed without an accountant's name thereon. Plain paper financial statements are not permitted, and the financial statements included in consulting reports are required to be at least compiled.

### ***Required Reviews***

**.06** An accountant is required to do a review only when engaged by his or her client to perform a review. Application of analytical procedures or other review-type procedures in a compilation engagement does not obligate the accountant to step up a compilation to a review engagement. For example, in a compilation engagement, if the accountant has concerns about a material account balance and resolves the matter by the application of review-type procedures (or even audit procedures), the accountant is not required to assess whether the expanded work causes the engagement to become a review. The accountant should report based on what the engagement letter or agreement calls for—in this case a compilation, not a review. This dovetails with Interpretation No. 13, "Additional Procedures" of SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.46–49). Interpretation No. 13 permits the accountant to perform additional procedures in a compilation or review engagement without requiring the accountant to change the level of the engagement. Furthermore, it is consistent with Interpretation No. 3, "Reporting on the Highest Level of Service," of SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.06–12). Interpretation No. 3 addresses engagements in which the accountant provides more than one level of service on the same financial statements. Interpretation No. 3 does not preclude the accountant from applying procedures that go beyond a compilation or a review and does not require the accountant to step up the engagement to another level of service.

### **Working Papers Requirements**

*What working papers are required for a compilation engagement?*

*What working papers are required for a review engagement?*

#### ***Compilation Working Papers***

**.07** SSARS No. 1 does not require any working papers for a compilation engagement. Nevertheless, accountants may find it helpful from a risk minimization and quality control perspective to include the following items in their client compilation engagement documentation:

1. Engagement letter
2. Trial balance information to bridge the client's records to the compiled financial statements
3. Notes on how incorrect, incomplete, or unsatisfactory matters were resolved, if any
4. If required by firm policy, compilation work program checklist and GAAP disclosure checklist

#### ***Review Working Papers***

**.08** SSARS No. 1 (AR sec. 100.31), states that in a review engagement the accountant should have working papers to describe the following:

1. Matters covered in the accountant's inquiry and analytical procedures such as matters listed in items a through g in AR sec. 100.27 and the inquiries included in appendix A of SSARS No. 1.
2. Unusual matters (incorrect, incomplete, or unsatisfactory information) that the accountant considered and how those matters were resolved.

In addition to these two items, accountants typically include the following in their review working papers:

1. An engagement letter
2. A bridging trial balance (See the preceding section entitled "Compilation Working Papers" above.)

3. The client's representation letter (SSARS No. 1, AR sec. 100.28, requires that a client provide the accountant with a representation letter in a review engagement.)
4. If required by firm policy for quality control purposes, a GAAP disclosure checklist, which the accountant might include (Because accountants cannot review financial statements that omit substantially all disclosures, checklists that include disclosure requirements are commonly used in review engagements.)

## Working Papers of Predecessor Accountants

*Are successor accountants required to obtain the working papers of predecessor accountants who compiled, reviewed, or audited the financial statements of the prior year?*

.09 SSARS No. 4, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2, AR sec. 400), does not require successor accountants to communicate with or obtain access to working papers of predecessor accountants in accepting compilation or review engagements. Nevertheless, if the successor accountant decides that circumstances justify communicating with the predecessor accountant and also decides that access to the predecessor's working papers may be useful, the successor accountant should inquire about the nature of the working papers before deciding that access would be helpful.

## Communications Between Predecessor Accountant and Successor Accountant

*If the prior year's financial statements are audited by a predecessor accountant and the successor accountant proposes to perform a review or compilation under SSARS No. 1, is the successor accountant obligated to communicate with the predecessor?*

.10 Neither SSARS No. 4 nor SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), applies if the prior year's financial statements are audited by a predecessor accountant and the successor accountant proposes to perform a review or compilation under SSARS No. 1. Accordingly, the successor accountant is not obligated to communicate with the predecessor. However, the successor accountant may find the guidance in SSARS No. 4 useful in generating information about whether to accept the engagement.

## Reporting on Comparative Financial Statements

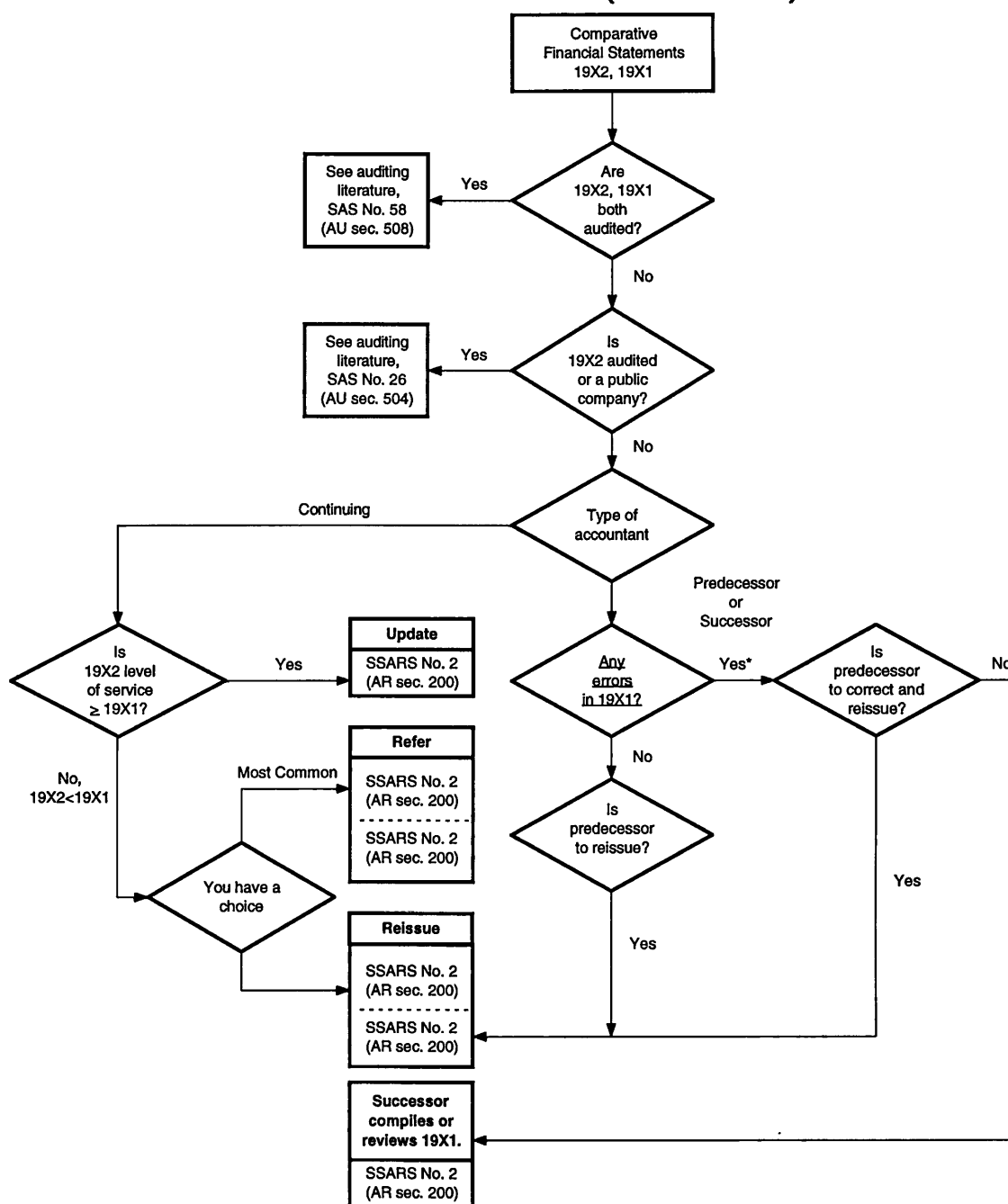
*What guidance is available to assist with reporting on comparative financial statements when a change of accountants or a change in the level of service has occurred?*

.11 SSARS No. 2, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 200), sets forth the authoritative requirements that obligate the accountant to report on each period when financial statements of two or more periods are presented in columnar form. Reporting is simple unless a change of accountants has occurred, the level of service (compilation or review) differs from period to period, or a change in the nonpublic status of the entity has occurred. In these situations, accountants face some rather complex reporting decisions. Because accountants don't frequently face these complexities, applying SSARS No. 2 can be daunting. A very useful flowchart (following this paragraph) can help to make SSARS No. 2 more user friendly. Accountants may consult the flowchart whenever questions about reporting on comparatives arise. All references in the flowchart are to SSARS No. 2. The flowchart covers both predecessor and successor accountants. The flowchart also references the appropriate SAS if the client's comparative financial statements are audited, such as SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), or if the client's status has changed from a nonpublic to a public entity, such as SAS No. 26, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 504).<sup>1</sup>

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<sup>1</sup> The flowchart is reproduced with permission from *Guide to Compilation and Review Engagements*, written by Clay, Guy, McMurrian, and McElroy (Fort Worth: Practitioners Publishing Company, 1998).

## Flowchart of SSARS No. 2 (AR sec. 200)



\* SSARS No. 4 (AR sec. 400.10) requires the successor to request the client to notify the predecessor when the successor believes that the prior-period financial statements need to be restated.

### .12 Here are some definitions from SSARS No. 2 that facilitate the use of the flowchart.

1. **Updated Report**—A continuing accountant issues this kind of report, which considers new information from the current engagement and re-expresses the previous conclusions or expresses different conclusions on the prior period financial statements as of the current report date.
2. **Reissued Report**—Issued subsequent to the date of the original report but bearing the same date as the original report, a reissued report may need to be revised and dual-dated for the effects of specific events.

To demonstrate the use of the flowchart, assume that a successor accountant is performing a review of the current year's financial statements. The prior year's financial statements were reviewed by another accountant. The prior year's financial statements had to be corrected because of an error in applying GAAP. The predecessor accountant has refused to correct and reissue the review report. Using the flowchart (following paragraph .11), what course of action should the successor accountant take? The answer is that the successor accountant will have to compile or review the prior year's financial statements, and he or she should not refer to the predecessor accountant in his or her report.

## Knowledge Acquired While Performing Accounting Services

*When SSARS No. 1 refers to "knowledge acquired in performing other accounting services," what does the phrase "may result in modification" mean?*

.13 According to SSARS No. 1 (AR sec. 100.29), knowledge acquired in performing other accounting services (such as providing bookkeeping or data-processing services) may result in the modification of the inquiries and analytical procedures performed in a review engagement. What does "may result in modification" mean?

.14 In a review, the accountant performs inquiries and applies analytical procedures to obtain a reasonable basis for expressing limited assurance on the financial statements. In practice, situations in which the accountant does a pure review are rare. That is, the accountant frequently performs other accounting services and may even compile the client's financial statements prior to performing the review engagement. In those situations, the accountant uses his or her knowledge, gained in the performance of those other services, to modify the inquiries and analytical procedures in areas in which additional evidence is needed to achieve limited assurance. Finally, in situations in which the accountant has compiled the financial statements, Interpretation No. 3 of SSARS No. 1 (AR sec. 9100.06-.12), states that the accountant should only issue the review report—the report appropriate for the highest level of service.

## Applying Analytical Procedures

*What kinds of analytical procedures does the accountant perform and how should they be applied?*

.15 SSARS No. 1 (AR sec. 100.04) states that a review consists of performing inquiry and analytical procedures to provide the accountant with a reasonable basis for expressing limited assurance on the financial statements. What kinds of analytical procedures does the accountant perform and how should those analytical procedures be applied?

.16 SSARS No. 1 (AR sec. 100.27(c)) indicates that analytical procedures consist of the following:

1. Comparison of financial statements with statements for comparable prior period(s)
2. Comparison of the financial statements with budgets and forecasts
3. Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern

Other kinds of analytical procedures may also be used to supplement some of the preceding three types. For example, if available, industry information may be used or relationships to nonfinancial information (for example, sales to square footage of selling space) may be used.

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

1. Identify immaterial account balances or classes of transactions. Apply no analytical procedures to them if the risk of understatement is low.

2. Identify account balances or classes of transactions in which you have applied significant other accounting services. Consider the evidence that you already have and whether any material errors are likely to remain—do not apply analytical procedures to them.
3. For remaining account balances and classes of transactions, develop expectations (for example, using historical trends adjusted for known changes) for them.
4. Consider how close the existing account balance or class of transactions comes to the expectation developed in item 3. If the results are close, no additional evidence is needed.
5. If the differences are large, material errors could exist. Inquire about valid business reasons for the difference. If results of inquiry are plausible and agree with other evidence, no additional evidence may be needed.
6. If additional evidence is needed, apply other analytical procedures or obtain other suitable evidence.

## Emphasis Paragraphs

*When should an accountant add a paragraph to a compilation or review report to emphasize a matter about the financial statements?*

.18 Footnote 18 of SSARS No. 1 (AR sec. 100) 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.” Footnote 18 permits, but never requires, an emphasis paragraph.

.19 Accountants frequently add voluntary emphasis paragraphs to compilation and review reports to call attention to matters disclosed in notes to the financial statements such as going-concern problems, litigation matters, and related-party transactions.

.20 When an accountant decides to add an emphasis paragraph, the following practice guidelines should be followed:

1. Emphasis paragraphs should not introduce new information about the financial statements; they should only highlight or emphasize a matter disclosed in the financial statements.
2. If the financial statements are deficient or do not contain a needed disclosure and the client does not correct the statements, the accountant is required to state, in a separate paragraph of the report, that the financial statements contain a departure from GAAP or OCBOA. This required paragraph differs from a voluntary emphasis paragraph.
3. Emphasis paragraphs should not contain information about the procedures the accountant has performed or has not performed.
4. Emphasis paragraphs should not contain the accountant’s conclusions or opinions.
5. If the accountant decides to add an emphasis paragraph to highlight a going-concern disclosure in the client’s financial statements, the term *substantial doubt* should not be used in that paragraph. (Substantial doubt is an audit-evidence-based concept that should only be used in audit reports.)

## Consulting on Complex Technical and Ethical Question

*Are accountants performing compilation and review engagements required to resolve complex technical and ethical questions through consultation? If consultation is used, should the working papers document the question and conclusion reached?*

.21 SSARS No. 1 (AR sec. 100.10 and 100.25) requires the accountant to possess or obtain a level of knowledge of the accounting principles and practices of the client’s industry. Such knowledge may be ob-

tained, among other ways, by consulting in-firm or outside firm individuals knowledgeable about the industry. Likewise, Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20.19), indicates that accounting firms should establish policies and procedures on consulting, on a timely basis, with individuals within or outside the firm, when appropriate for addressing complex, unusual, or unfamiliar issues. Finally, an interpretation of Rule 201 on general standards of the AICPA's *Code of Professional Conduct* (AICPA, *Professional Standards*, vol. 2, ET sec. 201.02), recognizes that consultation with others may be necessary during the performance of professional services.

.22 A widely used approach that many accountants use when addressing complex technical and ethical questions is to consult with the AICPA's Technical Hotline and the Ethics Hotline (see paragraph .45 for toll free telephone numbers).

.23 Good practice suggests that when consultation takes place and it involves complex technical or ethical questions, it's a good idea to document the following in the compilation or review working papers:

1. Individual(s) consulted
2. Description of question/problem
3. Conclusion reached
4. Firm's position on item 3 above

## A Reminder About Fraud

### *Does SAS No. 82, Consideration of Fraud in a Financial Statement Audit apply to compilation and review engagements?*

.24 In February 1997, the ASB issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Because of that standard and renewed emphasis on consideration of fraud in a financial statement audit, accountants frequently raise questions about applying SAS No. 82 in compilation and review engagements.

.25 SAS No. 82 does not apply to compilation and review engagements.<sup>2</sup> However, appendix A, "Review of Financial Statements—Illustrative Inquiries" of SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 100.52), indicates that an accountant in designing inquiries may consider the likelihood of misstatement. Compilation and review performance standards do not require an assessment of the risk of fraud. Nevertheless, according to SSARS No. 1, compilation performance standards (AR sec. 100.12) and review performance standards (AR sec. 100.30) do oblige the accountant to obtain additional or revised information when he or she becomes aware of information that is incorrect, incomplete, or otherwise unsatisfactory. The obligation to investigate questionable information emanates from the responsibility established in the *1136 Tenants' Corp.* case. That is, when suspicion is aroused, the accountant has to pursue the matter.

.26 In *1136 Tenants'*, the courts held the accountant liable to the client, a cooperative apartment corporation, for negligence in failing to detect fraud by the building manager. The court awarded damages of \$174,000, plus interest of \$60,000, less the accountant's counterclaim of \$1,000. The accountant's annual fee was \$600. In short, both SSARS No. 1 and the courts require accountants to investigate incorrect, incomplete, or otherwise unsatisfactory information. Don't put on blinders just because it's not an audit engagement. Investigate suspicious information and circumstances in all compilation and review engagements.

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<sup>2</sup> One of the changes introduced by SAS No. 82 is the substitution of the word *fraud* for *irregularities*. As a result of that change, editorial changes were made to the *Codification of Statements on Standards for Accounting and Review Services*, specifically to SSARS No. 1, to replace *irregularities* with *fraud*. In that process, the compilation and review engagement letters presented in appendices to SSARS No. 1 were also changed. The *Codification* issued as of January 1, 1998 reflected those changes (AICPA, *Professional Standards*, vol. 2, AR sec. 100.08, 100.53, and 100.54).



## Revision of the Review Representation Letter

*Does the ARSC plan to revise the illustrative review representation letter presented in appendix D of SSARS No. 1 to reflect the issuance of SAS No. 85?*

.27 In November 1997, the ASB issued SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), to expand, among other things, the list of specific representations to be obtained that are consistent with current practice and reflect new accounting standards. Does the ARSC plan to revise the illustrative review representation letter presented in appendix D of SSARS No. 1 (AR sec. 100.55)?

.28 Yes, ARSC has proposed certain updates to the illustrative representation letter to reflect recently issued accounting standards. The revisions will be treated as editorial changes (exposure is not required) to SSARS No. 1 and will become effective upon issuance. The revision should be available by year-end and will be announced in the *CPA Letter*.

## The Year 2000 Issue—Time Is Running Out

*What responsibility do accountants have for the year 2000 issue in compilation and review engagements? What year 2000 issue accounting guidance is available to help accountants follow GAAP in compiled or reviewed financial statements?*

.29 On January 1, 2000, at 12:00 a.m., some computer systems may begin to deliver wrong answers on date calculations. In fact, applications that use future dates may fail before January 1, 2000. The reason is that date calculations for many computer programs use two digits instead of four to represent years, such as 98 instead of 1998, to conserve what once was very expensive computer memory. In these programs, the year 2000 will be represented as 00. Some computer systems may recognize 00 as 1900 and not 2000.

.30 Another problem with many systems is that they have been programmed to recognize the year 99 to mean something other than the date. Thus, those systems may not function or they may produce incorrect information. Finally, another year 2000 problem is that the year 2000 is a leap year and some systems may not recognize the extra day.

.31 Year 2000 problems affect entity information systems that produce financial statements and operating systems such as production, security, and telephone systems. Even if a given client is year 2000 ready, that entity may still be at risk because of supplier, customer, and service entities that are not year 2000 ready. The year 2000 issue was addressed in last year's *Compilation and Review Alert—1997/98*. It remains the case that accountants have no responsibility when performing compilation and reviews to detect a client's year 2000 problems. Nevertheless, if the accountant becomes aware of financial statement information that is inaccurate, incomplete, or misleading, he or she must obtain revised or additional information without regard to its cause.

.32 To make sure that clients understand that a compilation or review engagement is not designed to detect whether an entity's information system is year 2000 ready, we suggested last year that the following be included in all compilation and review engagement letters.

.33 A compilation (review) of financial statements conducted in accordance with SSARSs is not designed to detect whether an entity's information systems are year 2000 ready. However, we may choose to communicate matters that come to our attention relating to the year 2000 issue for the benefit of management.

.34 The AICPA has issued nonauthoritative guidance relating to year 2000, available free of charge on the AICPA's Web site at <http://www.aicpa.org>. This document summarizes the applicable accounting and disclosure guidance, including EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*.

.35 EITF No. 96-14 indicates that internal and external costs associated with modifying existing internal-use hardware and software for year 2000 should be expensed as incurred. The costs should not be accrued or capitalized. Nevertheless, costs to replace existing systems with new systems that are year 2000 ready should be capitalized and written off over their estimated useful lives.

.36 If an entity voluntarily includes disclosures (for example, total costs incurred to date, total projected costs, and estimated date of completion) about year 2000 in notes to its financial statements, what responsibility does an accountant have for those items in a compiled or reviewed financial statement? The disclosures ordinarily should not be reviewed because of the difficulty of applying inquiry and analytical procedures to such information. The information could usually be compiled, but an alternative course of action is to recommend to the client that the information be presented as client-prepared supplementary information that is not compiled or reviewed. Under no circumstances should the disclosure, without regard to its location, state that the entity is year 2000 ready. Given all of the software and hardware applications related to accounting, operations, and compliance, it is very difficult to be certain that all systems are year 2000 ready.

.37 What responsibility does an accountant have for year 2000 matters in a compilation or review engagement that may cause the entity to have going-concern problems? According to Interpretation No. 11, "Reporting on Uncertainties," of SSARS No. 1 (AICPA, *Professional Standards*, vol. 2, AR sec. 100.33–40), the accountant's responsibility is to review the adequacy of disclosure about the going-concern problems. In evaluating the disclosure, the accountant is obligated to look to the guidance in paragraphs 10 and 11 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341.10 and .11). Year 2000 problems could cause conditions and events of the kind that might cause the entity to have a going-concern problem. The accountant may, but is not required to, read a June 1998 Auditing Interpretation No. 2 of SAS No. 59, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," issued by the ASB. The Interpretation provides examples of conditions and events caused by year 2000 (such as, revenue losses due to manufacturing equipment that is not year 2000 ready and year 2000 remediation costs in excess of available resources). These examples may be useful in helping an accountant evaluate going concern disclosures in compiled or reviewed financial statements.

## Disclosures in Cash- and Income Tax-Basis Financial Statements—A Reminder

*Are accountants required to consider GAAP disclosures in reporting on compiled or reviewed cash- and income tax-basis financial statements?*

.38 As discussed in the *Compilation and Review Alert—1997/98*, Interpretation No. 14, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax-Basis of Accounting" of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.88–.93), issued in January 1998, applies to compiled or reviewed cash- and income tax-basis financial statements. It states that if these financial statements have items for which GAAP would require disclosure, the statements should provide either the disclosure that would be required by GAAP or information that communicates the substance of that disclosure. The bottom line is that accountants have to know GAAP and what GAAP disclosures are to properly compile or review financial statements.

.39 This Interpretation will significantly affect many accountants who believed that accounting standards were developed solely for GAAP financial statements; therefore, GAAP standards do not apply to cash- and tax-basis financial statements. The debate is over. The guidance in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.10), has been clarified by Interpretation No. 14 to clearly state that cash- and tax-basis financial statements are required to have similar disclosure, although qualitative disclosures may be substituted for some quantitative GAAP disclosures. For example, disclosing estimated percentages of total revenues, rather than amounts, may convey the significance of certain related-party transactions. Given this clarification for those accountants who practiced otherwise, the best course of action is to study Interpretation No. 14 and consider the use of disclosure checklists modified when appropriate for cash- and income tax-basis financial statements. The AICPA also has published a new 1998 edition of a non-

authoritative book, *Preparing and Reporting on Cash-and Tax-Basis Financial Statements* (Product No. 006701). The new edition provides guidance on preparing and reporting on cash-and tax-basis financial statements, example financial statements, disclosures, and other practice aids.

## The GAAP Hierarchy for Compiled and Reviewed Financial Statements

*What publications are included in the hierarchy of “must-know”  
GAAP for accountants performing compilations and reviews?*

.40 Although there are different reporting and performance standards for compilation, review, and audit engagements, GAAP for compiled and reviewed financial statements are the same as those for audited financial statements. Footnote 3 of SSARS No. 1 (AR sec. 100.14) 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), is also applicable to compilations and reviews of financial statements performed under SSARSs.

.41 An exception to that rule is found in SSARS No. 1, which permits an accountant to compile financial statements that omit substantially all the disclosures required by GAAP (or OCBOA). If the accountant compiles such financial statements, he or she issues a special compilation report to alert readers to the fact that the disclosures have been omitted. An accountant is not permitted to review financial statements that omit substantially all the disclosures required by GAAP.

.42 Because several standard-setting bodies establish GAAP, there is no single publication that contains all the GAAP pronouncements. Each of the following publications contains certain pronouncements included in the GAAP hierarchy (that is, the “must-know” GAAP).

- *FASB Original Pronouncements—Accounting Standards*, a two-volume set, contains the original text of accounting pronouncements. It includes FASB Statements of Financial Accounting Standards and Interpretations, Accounting Principles Board 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* includes all Statements of Position and Practice Bulletins issued by the AcSEC. 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* contain 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)* are published by the FASB staff and provide guidance, in the form of questions and answers, on the implementation of certain FASB Statements (available from the FASB).
- 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 GASB).
- *AICPA Audit and Accounting Guides* summarize the practices applicable to specific industries and describe accounting principles and audit procedures unique to these industries. The accounting guidance included in AICPA Audit and Accounting Guides is in the GAAP hierarchy as authoritative GAAP. When an accountant compiles or reviews the financial statements of an entity, SSARS No. 1 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 industry background, accounting guidance, and illustrative financial statements that are provided should help accountants acquire knowledge of a specific industry. The following industry Audit and Accounting Guides are available from the AICPA (product numbers are shown in parentheses):

- Agricultural Producers and Cooperatives (012353)
- Airlines (013182)
- Banks and Savings Institutions (011177)
- Brokers and Dealers in Securities (012180)
- Casinos (013149)
- Colleges and Universities<sup>3</sup> (013323)
- Common Interest Realty Associations (CIRAs) (This Audit and Accounting Guide contains a chapter on compilations and reviews of CIRAs.) (012487)
- Construction Contractors (012095)
- Credit Unions (012058)
- Employee Benefit Plans (012338)
- Entities With Oil and Gas Producing Activities (012105)
- Federal Government Contractors (012437)
- Finance Companies (012465)
- Health Care Organizations (012438)
- Investment Companies (012362)
- Not-for-Profit Organizations (013391)
- Property and Liability Insurance Companies (011921)
- State and Local Governmental Units (012057)
- Voluntary Health and Welfare Organizations<sup>3</sup> (012158)

The following general Audit and Accounting Guides also may be of interest to CPAs performing compilation and review engagements:

- Personal Financial Statements (011135)
- Use of Real Estate Appraisal Information (013159)

## Recent GAAP Pronouncements

*What new GAAP pronouncements have been published since October 1997 (publication of last year's Compilation and Review Alert)?*

.43 New publications from the FASB include Statements, Technical Bulletins, and Emerging Issue Consensus Positions, which are listed in the following:

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (February 1998).

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<sup>3</sup> Use of these Guides is limited to certain governmental units accounted for under Statements on Governmental Accounting Standards No. 15, *Governmental College and University Accounting and Financial Reporting Models* and No. 29, *The Use of Not-For-Profit Accounting and Financial Reporting Principles by Governmental Entities*.

- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998).
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB Statement No. 65 (October 1998).
- FASB Technical Bulletin No. 97-1, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (December 1997).

## EITF CONSENSUS POSITIONS

EITF Issue No.	Description	Date of Consensus/Status
96-19	<i>Debtor's Accounting for a Substantive Modification and Exchange of Debt Instruments</i>	Implementation guidelines added July 23, 1998
97-2	<i>Application of APB 16 and SFAS 94 to physician's practice entities</i>	Consensus reached November 20, 1997
97-5	<i>Accounting for the Delayed Receipt of Option Shares Upon Exercise Under APB Opinion No. 25, Accounting for Stock Issued to Employees</i>	FASB Staff Announcement July 23-24, 1997
97-8	<i>Accounting for Contingent Consideration Issued in a Purchase Business Combination</i>	Consensus reached July, 1997
97-9	<i>Effect on Pooling-of-Interests Accounting of Certain Contingently Exercisable Options or Other Equity Instruments</i>	Consensus reached September 18, 1997
97-10	<i>The Effect of Lessee Involvement in Asset Construction</i>	Consensus reached May 21, 1998. (Changes made to consensus July 23, 1998)
97-11	<i>Accounting for Internal Costs Relating to Real Estate Property Acquisitions</i>	Consensus reached March 18, 1998
97-12	<i>Accounting for Increased Share Authorization in an IRS Section 423 Employee Stock Purchase Plan under APB Opinion No. 25, Accounting for Stock Issued to Employees</i>	Consensus reached September 18, 1997
97-13	<i>Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation</i>	Consensus reached November 20, 1997
97-14	<i>Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested</i>	Consensus reached May 21, 1998; Consensus reached on transition July 23, 1998.
97-15	<i>Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination</i>	Consensus reached March 18-19, 1998
98-1	<i>Valuation of Debt Assumed in a Purchase Business Combination</i>	Consensus reached March 18-19, 1998
98-2	<i>Accounting by a Subsidiary for an Investment in Its Parent Company's Stock</i>	No consensus reached. Further discussion expected.

EITF Issue No.	Description	Date of Consensus/Status
98-3	<i>Determining Whether a Transaction Is an Exchange of Similar Productive Assets or a Business Combination</i>	Further discussion planned March 18-19, 1998.
98-4	<i>Accounting by a Joint Venture for Businesses Received at Its Formation</i>	Further discussion planned March 18-19, 1998.
98-5	<i>Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios</i>	September 23-24, 1998 discussed but not asked to reach a consensus. Further discussion planned.
98-6	<i>Investor's Accounting For an Investment in a Limited Partnership Investment When The Investor Is The General Partner and the Limited Partners Have Certain Approval Or Veto Rights</i>	September 23-24, 1998. Further discussion planned.
98-7	<i>Accounting for Exchanges of Similar Equity Method Investments</i>	Consensus reached May 21, 1998.
98-8	<i>Accounting for Transfers of Investments that Are in Substance Real Estate</i>	Consensus reached May 21, 1998.
98-9	<i>Accounting for Contingent Rent in Interim Financial Periods</i>	September 23-24, 1998. Prior consensus on lessee accounting withdrawn, new consensus reached. Further discussion planned.
98-10	<i>Accounting for Energy Trading and Risk Management Activities</i>	September 23-24, 1998. Further discussion planned.
98-11	<i>Accounting For Acquired Temporary Differences In Certain Purchase Transactions That Are Not Accounted For As Business Combinations</i>	Consensus reached on one issue September 23, 1998. Further discussion planned.
98-12	<i>Application of EITF Issue No. 96-13, "Accounting For Derivative Financial Instruments Indexed To, and Potentially Settled In, A Company's Own Stock, To Certain Derivative Financial Instruments Issued with Other Instruments.</i>	September 23-24, 1998. Further discussion planned.
98-13	<i>Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee</i>	September 23-24, 1998. Further discussion planned.
98-14	<i>Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangements</i>	September 23-24, 1998. Further discussion planned.

**.44 New Statements of Position from the AICPA:<sup>4</sup>**

- SOP 97-2, *Software Revenue Recognition* (October 1997).
- SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments* (December 1997).

<sup>4</sup> SOPs 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*, and 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission*, are auditing pronouncements and are excluded.

- SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (March 1998).
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (March 1998).
- SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition* (March 1998).
- SOP 98-5, *Reporting on the Costs of Start-Up Activities* (April 1998).
- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*

## AICPA Services and Publications

*How do I obtain AICPA publications related to my compilation and review practice?*

.45 To order AICPA products, call (888) 777-7077 (menu selection #1); write AICPA Order Department, CLA 10, 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. Obtaining product information and placing online orders can be done at the AICPA's Web site <http://www.aicpa.org>.

*Who do you consult with at the AICPA if you have a complex technical or ethics question related to compilation or review practice?*

- Accounting and Auditing Technical Hotline. The AICPA Technical Hotline answers members' inquiries about compilation and review services. Call (888) 777-7077.
- Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

.46 What's a good way to stay current on developments in the compilation and review arena? The AICPA has 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 compilation, review, and accounting. The home page is updated daily. The Web site includes "In Our Opinion," the newsletter of the AICPA Audit and Attest Standards Team. The newsletter includes information on technical activities and developments in compilation and review matters. The Web site also includes highlights of ARSC meetings.

.47 What's a good source for keeping up with authoritative pronouncements that affect compilation and review engagements? Practitioners Publishing Company (PPC) and the AICPA currently offer a CD-ROM disk, *The Practitioner's Library—Accounting and Auditing*. Publications issued by PPC, the AICPA, and the FASB are included in *The Practitioner's Library*. 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* (which includes all of the SSARs and their interpretations), *Technical Practice Aids*, *Audit and Accounting Guides*, and the *Peer Review Program Manual*. 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 (888) 777-7077.

.48 Are there other AICPA publications that cover compilation and review engagements that may be useful? The following AICPA publications include guidance relevant to compilation and review engagements (product numbers are shown in parentheses):

- *Audit and Accounting Manual* (007259)—The manual is designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations.
- *Financial Statement Preparation Manual/Disclosure Checklists* (G01027)—The manual is a loose-leaf service of nineteen disclosure checklists and sample financial statements for various industries that is updated quarterly to reflect the issuance of new authoritative guidance. The checklists are the individual paperback versions that are generated from the loose-leaf and published annually.

## New CPE Course on Compilation and Review

*What is the best CPE course for getting a basic understanding of SSARS Nos. 1 to 7 or introducing new staff accountants and paraprofessionals to those standards?*

.49 During the four years of extensive discussions, debates, comment letters, and public hearings about the assembly exposure draft and the applicability of the SSARS (see the second section of this Compilation and Review Alert), one item emerged that everyone agreed on—the need for additional education about compilation and review standards.

.50 Quite frankly, a number of individuals writing comment letters or participating in the discussions and debates on the assembly exposure draft demonstrated a significant misunderstanding about the fundamental requirements of the existing standards—what's required and what's not. Consequently, one of the things that the AICPA promised to do was to develop a new CPE course for self-study and for group study on the compilation and review standards. That has been done and the course is in production. Starting with the 1999 CPE year, the AICPA will be offering a new *Introduction to Compilation and Review Engagements*, written by Dan M. Guy, the former Vice President at the Institute in charge of compilation and review standards.

.51 The *Compilation and Review Alert*—1998/99 is published annually. As you encounter problems in performing compilation and review engagements, please share those with us so that next year's Compilation and Review Alert will be even better. You may email these comments to [dmguy@worldnet.att.net](mailto:dmguy@worldnet.att.net) or write to:

Dan M. Guy, Ph.D., CPA  
314 Paseo de Peralta  
Santa Fe, NM 87501



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## Appendix A

### The Internet—An Accountant's Research Tool

Here is a listing of some useful Web sites that may provide valuable information to accountants doing compilations and reviews.

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
American Institute of CPAs	Summaries of recent developments at the ARSC and other professional standard-setting committees and other AICPA activities	<a href="http://www.aicpa.org">http://www.aicpa.org</a>
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	<a href="http://www.fasb.org">http://www.fasb.org</a>
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	<a href="http://www.gasb.org">http://www.gasb.org</a>
CPAnet	Links to other Web sites of interest to CPAs	<a href="http://www.cpalinks.com">http://www.cpalinks.com</a>
Accountant's Home Page	Resources for accountants and financial and business professionals	<a href="http://www.computercpa.com">http://www.computercpa.com</a>

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## Appendix B

### Test Your Knowledge

For the questions and statements shown below, indicate whether the statement is true or false or select the correct answer for multiple choice questions.

- \_\_\_\_\_ 1. SSARS No. 1 permits a paraprofessional to perform the compilation engagement, but the paraprofessional should not issue the compilation report.
- \_\_\_\_\_ 2. Which of the following is not a specific exemption from certain aspects of SSARS No. 1?
  - a. Litigation support services
  - b. Tax returns
  - c. Financial statements in a consulting engagement
  - d. Certain prescribed forms
- \_\_\_\_\_ 3. An accountant is required to do a review only when engaged to do so.
- \_\_\_\_\_ 4. Although working papers are not required in a compilation engagement, which of the following items would least likely be included in compilation engagement working papers?
  - a. Representation letter
  - b. Engagement letter
  - c. Resolution of questionable items
  - d. Bridging trial balance
- \_\_\_\_\_ 5. GAAP disclosure checklists are more commonly used in compilation engagements than in review engagements.
- \_\_\_\_\_ 6. A successor accountant is required to communicate with the predecessor accountant before accepting an engagement to review the current year's financial statements.
- \_\_\_\_\_ 7. A continuing accountant is required to update his or her report on comparative financial statements (years 1998/1999).
- \_\_\_\_\_ 8. An accountant who performs bookkeeping services for a client followed by a review engagement cannot consider evidence generated from the bookkeeping work as evidence to support the review report.
- \_\_\_\_\_ 9. If a client has a going-concern problem, the accountant's compilation or review report must call attention to the problem by the addition of an emphasis paragraph.
- \_\_\_\_\_ 10. SSARS No. 1, under certain circumstances requires consultation to resolve complex and material technical issues.
- \_\_\_\_\_ 11. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, does not apply to compilation or review engagements.
- \_\_\_\_\_ 12. An accountant has a responsibility to detect a client's Y2K problem in a review engagement, but not a compilation engagement.
- \_\_\_\_\_ 13. In preparing modified cash financial statements that are compiled, the accountant should be familiar with and consider GAAP disclosures where applicable.

- \_\_\_\_\_ 14. The GAAP hierarchy for compiled and reviewed financial statements is the same as for audited financial statements.
- \_\_\_\_\_ 15. An AICPA audit and accounting guide addressing a specialized industry may be useful to an accountant compiling or reviewing financial statements in that industry but is not part of the GAAP hierarchy.

**Answers to Test Your Knowledge:**

1. False, the paraprofessional may also issue the report. 2. c 3. True 4. a 5. False 6. False 7. True 8. False 9. False, the accountant may elect to do so. 10. False 11. True 12. False 13. True 14. True 15. False

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*[The next page is 8105.]*



# AAM Section 8030

## *Health Care Industry Developments—1998/99*

### In This Year's Alert . . .

- What are the industry and economic conditions facing health care organizations in the current year?
- What significant regulatory and legislative initiatives should auditors of health care organizations be aware of?
- What are some of the adverse consequences facing health care organizations that do not have an effective compliance program?
- How do the amendments to the Single Audit Act affect audits of federal awards?
- What are the current tax issues that may affect audits of health care organizations?
- What are the significant provisions of the Balanced Budget Act of 1997 that will affect health care organizations in the current year?
- How will the new SOP 98-3 assist auditors in performing audits of federal awards?
- What effect do the allegations of violations of laws and regulations in the health care industry have on this year's audits?
- Can obligated group financial statements be included in a public offering?
- What is the Year 2000 Issue? How will it affect health care organizations?
- What are the recently issued auditing and accounting pronouncements affecting health care organizations?
- What are some issues of concern this year for health care organizations subject to SEC regulations?
- What other AICPA publications can be of value to auditors of health care organizations?

\* \* \* \*

### Industry and Economic Developments

*What are the industry and economic conditions facing  
health care organizations in the current year?*

.01 The demand for health care services continues to trend upward in 1998 due largely to the baby-boom generation. As this population segment ages, driving up the average age of the American people as a whole, and as the number of people with chronic conditions grows, overall health care spending will continue to climb.

.02 Despite increasing demand, however, health care organizations are feeling pressure from the bill-payers—predominantly employers, third-party payers, and the government—for more efficiency in a system with too much capacity and too few productivity improvements. The federal government is aggressively pursuing health care cost savings, in large part to balance the federal budget. More private-market

approaches are being adopted, and greater resources are being allocated to the ongoing crackdown on fraud, waste, and abuse in governmental health care programs. The impact on auditors of efforts to uncover fraud in governmental programs is addressed in this Audit Risk Alert, in the Regulatory, Legislative, and Other Developments section, under Governmental Investigations Relating to Fraud and Abuse Violations.

.03 Managed care plans are also feeling pressure for more efficiency, reduced utilization, better quality measures, and increased choice to recipients. In an effort to maintain and grow market share in recent years, managed care plans did not increase premiums sufficiently to cover significant cost increases. As a result, many managed care plans, both regional and national, now find themselves operating at losses and have a need to increase premiums substantially, against significant employer resistance. Further, many state governments, which have shifted to Medicaid managed care, have begun to curtail funding. Consequently, many managed care plans that rely substantially on Medicaid enrollment are suffering significant operating losses, while others are curtailing Medicaid managed care growth initiatives. Auditors should consider whether such circumstances raise going-concern issues or suggest the presence of fraud risk factors.

.04 Consumers are becoming more demanding for greater responsiveness from health care organizations while also having higher expectations of service. Quality of service is therefore more likely to take the center stage as health care organizations seek a competitive advantage by investing more in the measures and standards of quality. Consumers' desire for greater choice and availability will also grow.

.05 Thus, health care organizations increasingly find themselves caught between the cost-conscious major purchasers of health care services on the one hand, and service-conscious individual consumers on the other. One of the means through which organizations are achieving the dual objectives of cutting health care costs and increasing the quality of services provided is by combining resources. The numbers of independent hospitals and physicians continue to diminish, as most of them join organizations that have greater power to negotiate prices. Undercapitalized physician groups are being forced increasingly to align with hospital systems or physician practice management companies (PPMs) (the exceptions are large multi-specialty groups with a strong primary care physician base). As a result, most industry sectors, including both for-profit and not-for-profit entities, are consolidating. This trend points to continuing concentration in an industry increasingly dominated by large and capital-intensive providers.

.06 The number of mergers and acquisitions announced last year rose by nearly 19 percent, but this was a slower rate than the prior year. That deceleration will likely continue in the near term, as recently acquired health care organizations and facilities are assimilated. Nevertheless, as long as the average hospital is filling just 60 percent of its beds, merger pressure will continue. As health care gradually shifts from more costly settings to home and noninstitutional care, the drive to reduce capacity is also prompting consolidation in nursing homes, assisted-living centers, providers of home health care, and other lower-cost alternatives to hospital beds. The movement of large, well-capitalized providers into these traditionally fragmented industry segments underlies the consolidation trend. Investor-owned physician management companies, which continue to grow in number, are also choosing to consolidate. A comprehensive discussion of the auditing and accounting issues that arise out of the business combinations is addressed in the AICPA *Audit Risk Alert—1998/99* [AAM section 8010].

.07 With consolidation comes dramatic change in the structure of an entity. In an effort to create greater cost efficiencies, departments are combined and duplicate functions are eliminated. Auditors should consider the impact of such changes on their client's internal control. Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), outlines the auditor's responsibilities with regard to considering a client's internal control in planning and performing an audit. In addition, auditors should consider whether management has appropriately accounted for the consolidation. For example, goodwill arising in purchase transactions may be an especially judgmental area and is therefore likely to require close scrutiny. The issue of goodwill as it relates to entities reporting to the Securities and Exchange Commission (SEC) is addressed in the Accounting Issues and Developments section of this Alert.

.08 Competitive forces are strong within the industry and are particularly a threat to smaller, local health care organizations. Many health care enterprises are regional and national, with major players capable of moving into new markets within a very short time frame. Market segments unheard of just a few years ago, such as physician practice management, get major infusions of Wall Street capital and become forces to reckon with overnight. Changes in policy emphasis from Washington create new forms of competition, such as Medicare and Medicaid managed care. Auditors should consider the effect of such competitive forces on their client's ability to continue as a going concern. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to the auditor in conducting an audit in accordance with generally accepted auditing standards (GAAS) with respect to evaluating whether there is substantial doubt about an entity's ability to continue as a going concern.

.09 In the past, concentrations of credit risks for many health care organizations have generally been confined to the amount of business or receivables outstanding with governmental payers (Medicare and Medicaid). In recent years, however, many governmental payers have turned to private managed care plans for health care services. As a result, governmental payers no longer make up the majority of receivables of some health care organizations. These organizations may now find that a significant amount of their business activity or receivables relies on potentially insolvent organizations, such as managed care plans that are suffering operating losses. In addition, certain managed care plans may have a concentration of significant business activity with major employers of a community, state government, or both through the Medicaid managed care initiatives of that state. In certain states, many Medicaid-reliant managed care plans find themselves operating at significant losses due in large part to reduced state government funding of Medicaid managed care premiums. In such circumstances, auditors should consider whether a health care organization's management has followed the guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), to ensure that appropriate disclosures have been made regarding credit risk concentrations.

.10 Health care organizations are increasingly shifting their attention to the essentials of information technology, placing more emphasis on, and investment in, basic information technology infrastructure. Among the top priorities include the computerization of patient records, and as consumers demand more health care information, doctors, hospitals, and health plans are becoming more active in relaying that information to consumers, especially through the Internet. As a result, auditors of health care organizations are increasingly likely to be confronted with evaluating evidential matter that may exist only in an electronic format. Traditional source documents are increasingly being replaced by electronic communications between the audit client and its patients and vendors. SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically.

#### **Executive Summary—Industry and Economic Developments**

- The demand for health care services continues to trend upward; however, health care organizations are feeling pressure from bill payers for more efficiency in a system burdened by excess capacity and minimal productivity improvements.
- To meet consumer demands, health care organizations are striving to cut costs and increase quality by combining resources. Thus, industry mergers and acquisitions continue in the current year, though at a slower rate than previous years.
- Competitive forces within the industry remain strong, and may call into question some entities' ability to continue as a going concern. 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*.
- Health care organizations are increasingly placing more emphasis on, and investment in, basic information technology infrastructure. As such, auditors should be familiar with the guidance set forth in SAS No. 31, *Evidential Matter*.

## Regulatory, Legislative, and Other Developments

*What significant regulatory and legislative initiatives should auditors of health care organizations be aware of?*

### Governmental Investigations Relating to Fraud and Abuse Violations

.11 The federal government and many states have aggressively increased enforcement efforts under Medicare and Medicaid antifraud and abuse legislation. Thus far, those efforts have achieved significant success. For example, in fiscal 1997 alone, the Health and Human Services Office of Inspector General (OIG) reported \$1.2 billion in recoveries. As such, these enforcement efforts appear likely to increase during 1998 and beyond.

.12 Laws addressing false claims for payments under a federal health care program (including Medicare and Medicaid) and applications of the civil False Claims Act to such claims are exposing health care organizations to potential civil penalties ranging from \$5,000 to \$10,000 per false claim and treble damages. A whistle-blower statute that rewards private parties for false-claim identification has spurred enforcement activity and increased provider risk. Recent broad interpretations of these statutes by federal enforcement agencies and whistle-blowers are exposing billing violations and unlawful remuneration arrangements to scrutiny and penalty consideration as potential false claims. In addition, the government has recently begun to investigate managed care plans for denying medically necessary care.

.13 Similarly, as a result of recent legislative changes criminalizing false statements made in connection with private health care benefits, fraud against private insurers and self-insured employers can now be more easily prosecuted by government authorities. Meanwhile, private insurers are apparently increasing their own efforts to detect fraudulent activities (including false claims and kickbacks) and recoup related reimbursements, sometimes based on the Racketeer Influenced and Corrupt Organizations (RICO) law.

.14 Although government investigations may focus on a broad range of practices, the OIG has indicated that the following areas are of special concern:

- Assignment of inappropriate Diagnosis-Related Groupings (DRGs), for example, related to pneumonia
- Billing for items and services not rendered, and providing medically unnecessary services
- "Upcoding," or using a code that provides for higher payment than what reflects the service actually provided
- Claims for outpatient services that should have been considered part of an inpatient stay
- Teaching hospitals' practices of billing for services actually performed by interns and residents (Physicians At Teaching Hospitals or [PATH] initiative)
- Duplicate billing (more than one claim for the same service or filing claims with multiple primary payers), false cost reports (particularly, home health agencies and other providers continuing to be cost reimbursed), unbundling (fragmenting what is considered a single service—for example, a lab test—to increase reimbursement), and billing for a patient discharge rather than a transfer
- Patients' freedom of choice, particularly related to discharge planning activities
- Failure to refund credit balances
- Hospital incentives that violate the antikickback statutes or other similar federal or state laws (including excessive payments to physicians for services or for their medical practices)
- Joint ventures or other financial arrangements between hospitals and hospital-based physicians



- The Limitations on Certain Physician Referrals law, also known as the Stark physician self-referral law (see the Stark II Issues section of this Audit Risk Alert for more information)
- A knowing failure to provide covered services or necessary care to a member of a health maintenance organization (HMO)
- Patient dumping

The Balanced Budget Act of 1997 (BBA), as described in the New Issues discussion later in this section, did not make fundamental changes to the fraud and abuse laws to the same extent as the previous year's Health Insurance Portability and Accountability Act. However, the BBA provides for imposition of a civil money penalty of \$50,000 and damages of up to three times the amount of money involved against an entity that: (1) arranges or contracts with an individual or entity that it knows or should know has been excluded from a federal health care program; or (2) violates the antikickback provision of the Medicare and Medicaid statute.

.15 This heightened enforcement activity should remind auditors of their professional responsibilities pursuant to SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), in planning and performing their audits of health care organizations. The discussion titled Fraud and Abuse in the Health Care Industry in the Audit Issues and Developments section of this Audit Risk Alert has additional information.

## Corporate Compliance

*What are some of the adverse consequences facing health care organizations that do not have an effective compliance program?*

.16 Government enforcement activities such as those discussed in previous sections have brought corporate compliance to the planning forefront for many health care organizations. The formal adoption of a corporate compliance program can assist a health care organization in avoiding unlawful activities, detecting such activities before significant potential damages are incurred, and establishing that any unlawful activities in which it was engaged were inadvertent. A written corporate compliance program should consist of procedures and controls to prevent, detect, and correct wrongdoing within an organization based on the standards included in the Federal Sentencing Guidelines. Potential adverse consequences to health care organizations of not having an effective compliance program include the following:

- Probation and court-imposed program
- Government-designed integrity program
- Fines in amounts sufficient to divest the organization of all its net assets
- Exclusion from Medicare, Medicaid, or both
- Civil liability

In addition, it is of interest to note that a recent court ruling suggests that, in certain instances, a health care entity's board of directors may have breached its fiduciary duty by not considering the adoption of a compliance plan.

.17 Corporate compliance programs are an integral part of an organization's internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, explains how an independent auditor should consider internal control in planning and performing an audit. Auditors may wish to consider communicating with the client's board of directors or committee thereof about the organization's activities or plans regarding corporate compliance. If an organization does not have an effective corporate compliance program, the auditor should determine whether this represents a reportable condition to be reported to the audit committee. SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional*

*Standards*, vol. 1, AU sec. 325), provides guidance in identifying and reporting conditions related to an entity's internal control that are observed during a financial statement audit.

### ***Guidance for Corporate Compliance***

.18 The OIG recently issued *Compliance Program Guidance for Hospitals* (Compliance Guidelines). This publication is intended to help hospitals implement effective internal control that promotes adherence to applicable federal and state laws and program requirements of federal, state, and private health plans. As explained by the OIG, a hospital's compliance plan should demonstrate its commitment to compliance, and "... should become part of the fabric of routine hospital operations."

### ***Components of the Compliance Guidelines***

.19 ***Compliance Policies.*** Hospitals should develop and distribute written compliance policies that identify specific areas of risk to the hospital, including those specified in the Governmental Investigations Relating to Fraud and Abuse Violations section of this Alert. These policies and procedures should reflect and reinforce current legal requirements regarding submission of claims and Medicare cost reports and should—

- Create a mechanism for effective communications between billing or reimbursement staff and clinical staff.
- Provide for proper, timely, and legible documentation of all physician and other services before billing to ensure accuracy.
- Emphasize that claims should be submitted only when there is supporting documentation and require that information on claims reflect medical records and the availability of documentation necessary for accurate code assignment to coding staff.

In addition, compensation for billing department coders and billing consultants should not provide a financial incentive to improperly "upcode" claims.

.20 ***Standards of Conduct.*** Hospitals should develop written standards of conduct (that is, employee handbooks) for all affected employees that include a clear commitment to compliance by the hospital. Hospitals should designate a compliance officer and provide the officer with authority necessary to implement the compliance program. The compliance function should not be subordinate to the hospital's general counsel or financial officer.

.21 ***Education and Training.*** A hospital should require corporate officers, managers, employees, physicians, and other health care professionals to participate in regularly scheduled education and training activities. Training programs should address the hospital's compliance program, fraud and abuse laws, coding requirements, claims development and submission processes, and marketing practices. In addition to specifically identified risk areas, the educational programs should address—

- Government and private payer reimbursement principles.
- General prohibitions on paying or receiving remuneration for referrals.
- Proper confirmation of diagnoses.
- Claims for physician services rendered by nonphysicians (that is, the "incident to" rule and the physician physical-presence requirement).
- Prohibitions against signing a form for a physician without the physician's authorization, altering medical records, or prescribing medications and procedures without proper authorization.
- Proper documentation of services rendered.
- Duty to report misconduct.

Hospitals should maintain an open line of communication between the compliance officer and hospital personnel using a hotline (including an anonymous hotline), email, written memoranda, and newsletters. Employees should be permitted to report matters anonymously. Written confidentiality and nonretaliation policies should be developed and distributed to encourage reporting. The compliance officer should document and immediately investigate all reported matters and should maintain a log of calls. Information relating to reported incidents should be reported to the hospital's governing body, chief financial officer, and compliance committee.

**.22** An effective compliance program should include guidelines addressing disciplinary action for corporate officers, managers, employees, physicians, and other health care professionals who fail to comply with the hospital's standards of conduct, policies and procedures, or federal and state law. Intentional or reckless noncompliance should result in significant sanctions. Disciplinary actions may also be appropriate, based on an employee's failure to detect a violation resulting from his or her negligence or recklessness.

**.23 *Precautions Against Employing Health Care Offenders.*** Hospitals should conduct a reasonable background investigation of any new employee who will have discretionary authority regarding legal compliance or compliance oversight, including a reference check. The applicant should be required to disclose any prior criminal conviction or exclusion action. Employment of individuals recently convicted of a criminal offense related to health care, or debarred, excluded, or otherwise ineligible for participation in a federal health program should be prohibited.

**.24 *Auditing and Monitoring.*** Hospitals should continually audit and monitor their compliance programs, conducting regular compliance audits focusing on the programs, including their external relationships with third-party contractors. Regular, periodic compliance audits by internal or external auditors with expertise in federal and state regulatory requirements is an effective tool to promote and ensure compliance. These audits should address a hospital's compliance with applicable laws. Self-monitoring techniques may include sampling protocols that permit review of variations from established baselines and a review of any reserves the hospital has established for payments owed to a federal health care program to evaluate the need for repayment.

**.25** A hospital should evaluate periodically whether elements of its compliance program have been satisfied by conducting on-site visits, personnel interviews, and trend analyses to discover specific deviations. Additional auditing activities may include use of personnel questionnaires and review of records supporting claims for reimbursement and materials prepared by various hospital divisions. The hospital should document efforts to comply with various regulatory requirements.

**.26 *Responding to Reported Offenses.*** A hospital should respond to "detected offenses" and develop corrective action initiatives. The OIG emphasizes that "detected but uncorrected misconduct can seriously endanger the mission, reputation, and legal status of the hospital." Consequently, upon receipt of any report or reasonable indication of noncompliance, the hospital should determine whether a violation of the law or compliance program has occurred, and if so, resolve the problem, including, as appropriate, an immediate referral to law enforcement authorities, a corrective action plan, a report to the government, and return of overpayments. A hospital with credible evidence of misconduct in violation of applicable law should report the misconduct to the appropriate government authority within sixty days to "demonstrate the hospital's good faith and willingness to work with governmental authorities to correct and remedy the problem."

**.27** In addition to the corporate compliance guidance for hospitals, the OIG also published compliance program guidance for clinical laboratories and home health agencies. The OIG is also expected to issue compliance guidance for other health care organizations, such as durable medical equipment suppliers and managed care organizations. Until such guidance is issued, these organizations should refer to the existing OIG compliance guidelines.

.28 The OIG's Web site contains the full text of all compliance program guidance as well as its semiannual reports and work plans. The Web site can be located at <http://www.dhhs.gov/progorg/oig>.

### Executive Summary—Corporate Compliance

- Government enforcement activities have brought corporate compliance to the planning forefront for many health care organizations. A formal corporate compliance program can assist in avoiding unlawful activities, detecting such activities before damages are incurred, and establishing that any unlawful activities were inadvertent.
- Auditors of health care organizations that do not have an effective program in place should consider whether this constitutes a reportable condition to be reported to the audit committee. SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance in such circumstances.
- The OIG's *Compliance Program Guidance for Hospitals* outlines the components of compliance guidelines, which include: compliance policies, standards of conduct, education and training, precautions against employing health care offenders, auditing and monitoring, and responding to reported offenses.

## Major Changes to Single Audits of Federal Awards

*How do the amendments to the Single Audit Act affect audits of federal awards?*

### Single Audit Act Amendments of 1996

.29 Legislation amending the Single Audit Act of 1984 (Public Law 104-156), was signed into law on July 5, 1996, as the Single Audit Act Amendments of 1996 and is effective for fiscal years beginning after June 30, 1996. A brief description of the 1996 amendments as contrasted with the Single Audit Act of 1984 is shown in the following table.

	1996 Act	1984 Act
Applicability	State and local governments, Indian tribal governments, and not-for-profit organizations (including hospitals)	State and local governments and Indian tribal governments
Single audit threshold	\$300,000 in federal awards <i>expended</i> in year	\$100,000 in federal assistance <i>received</i> in year
Major federal program	Generally determined by the auditor on a risk-based approach	Larger of \$300,000 or 3% of federal financial award expenditures
Reporting deadline	Within 9 months of year end (after transition period)	Within 13 months of year end
Program-specific audits	Permitted if \$300,000 or more expended is for 1 federal program	Not addressed

Copies of the 1996 amendments are available through the AICPA Fax Hotline, by dialing (201) 938-3787 from a fax machine and selecting document number 402.

### OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

.30 On April 22, 1996, the Office of Management and Budget (OMB) issued a revised Circular A-133, applicable only to not-for-profit organizations. Once the 1996 amendments were passed (see the discussion

in the previous section), it became necessary for the OMB to propose another revision to OMB Circular A-133 to add state and local governments to the scope of the Circular, to comply with certain other aspects of the 1996 amendments, and to rescind Circular A-128, which is the existing regulation governing audits of federal awards for states and local governments. The revised Circular A-133 was issued on June 30, 1997, and it applies to audits of fiscal years beginning after June 30, 1996.

.31 The major differences between the revised Circular A-133 and Circulars A-128 and A-133 are outlined in the following table.

	<i>Revised A-133</i>	<i>A-128</i>	<i>A-133</i>
Applicability	State and local governments, Indian tribal governments, and not-for-profit organizations (including hospitals)	State and local governments and Indian tribal governments	Not-for-profit organizations
Audit Threshold	\$300,000 expended, single audit if more than 1 federal program	\$100,000 received, mandatory single audit	\$100,000 received, either single audit or program-specific audit
	\$300,000 expended, program-specific audit if only one program	\$25,000–\$100,000 received, option for single audit or program-specific audit	\$25,000–\$100,000 received, option for single audit or program-specific audit
	Below \$300,000 expended, no single audit requirements	Below \$25,000 received, no audit required	Below \$25,000 received, no audit required
Major federal program	Generally determined by the auditor on a risk-based approach	Larger of \$300,000 or 3% of federal financial award expenditures	Larger of \$100,000 or 3% of federal financial award expenditures
Reporting deadline	Within 9 months of year end (after transition period)	Within 13 months of year end	Within 13 months of year end

Some additional provisions of the revised Circular include the following:

- 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.
- 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 effective for audits of fiscal years beginning after June 30, 1998.

.32 As a result of the issuance of the 1996 amendments and revisions to OMB Circular A-133, questions have arisen about 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.

.33 For a copy of the revised Circular A-133, refer to the June 30, 1997, *Federal Register* or call the OMB Fax Information Line at (202) 395-9068, document number 1133.

### Compliance Supplement

.34 In the June 10, 1998, *Federal Register*, OMB published notice of the availability of the 1998 Circular A-133 *Compliance Supplement* (1998 Supplement). The revised OMB 1998 *Compliance Supplement* supersedes all previously issued Supplements and sets forth the material compliance requirements that are to be included in an audit in accordance with OMB Circular A-133. It covers states, local governments, and not-for-profit organizations and applies to audits of fiscal years beginning after June 30, 1997. The significance of this document is stated in Part I of the *Compliance Supplement*:

This document serves to identify existing important compliance requirements which the Federal Government expects to be considered as part of an audit required by the 1996 amendments. Without this Supplement, auditors would need to research many laws and regulations for each program under audit to determine which compliance requirements are important to the Federal Government and could have a direct and material effect on a program. Providing this Supplement is a more efficient and cost effective approach to performing this research. For the programs contained herein, this Supplement provides a source of information for auditors to understand the Federal program's objectives, procedures, and compliance requirements relevant to the audit as well as audit objectives and suggested audit procedures for determining compliance with these requirements.

This Supplement also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included herein. For single audits, this Supplement replaces agency audit guides and other audit requirement documents for individual Federal programs.

OMB Circular A-133 provides that Federal agencies are responsible to annually inform OMB of any updates needed to this Supplement. This responsibility includes ensuring that program objectives, procedures, and compliance requirements, noncompliance with which could have a direct and material effect on these individual Federal programs, are provided to OMB for inclusion in this Supplement, and that agencies keep current these program objectives, procedures, and compliance requirements (including statutory and regulatory citations).

A copy of the *Compliance Supplement* may be ordered from the Government Printing Office (Document 041-001-00507-2). See the Information Sources table at the end of this Audit Risk Alert (under U.S. General Accounting Office).

### ***AICPA Statement of Position***

.35 Given the changes described in the preceding 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 has issued a new SOP that supersedes them. SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, was issued on March 17, 1998, and provides guidance on the auditor's responsibilities and reporting requirements for audits performed and corresponding reports issued under the 1996 amendments and OMB Circular A-133. It also includes revised simplified single audit illustrative audit reports that include one report on the financial statements, one report that meets the requirements for reporting on compliance and internal control under Government Auditing Standards (GAS, also known as the Yellow Book), and one report that meets the requirements of the 1996 amendments and OMB Circular A-133 for reporting on single audits of federal awards. See the Auditing Issues and Developments section of this Alert for a more detailed discussion of the provisions of SOP 98-3.

.36 In addition, the AICPA Practice Aid *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB A-133*, *Audits of States, Local Governments, and Non-Profit Organizations*, contains comprehensive analyses and guidance on implementing the provisions of the revised OMB Circular.

.37 The illustrative reports can be obtained through the AICPA Fax Hotline—by dialing (201) 938-3787 from a fax machine and selecting document number 311—or at the AICPA Web site, [www.aicpa.org/belt/a133.htm](http://www.aicpa.org/belt/a133.htm).

#### **Executive Summary—Major Changes to Single Audits of Federal Awards**

- The Single Audit Act Amendments of 1996 made changes to the Single Audit Act of 1984 with regard to applicability, audit threshold, major federal program, reporting deadline, and program-specific audits. In response to these changes, OMB Circular A-133 was revised to conform to the 1996 act and OMB Circular A-128 was rescinded.
- A revised OMB 1998 *Compliance Supplement*, which became available in June 1998, sets forth material compliance requirements that are to be included in an audit in accordance with OMB Circular A-133. The Supplement is an efficient and cost-effective approach to researching the laws and regulations for each program under audit to determine which compliance requirements are important to the federal government and that could have a direct and material effect on the program.
- The AICPA SOP 98-3 provides guidance on the work performed and the reports issued for audits under the 1996 amendments and OMB Circular A-133.

### **Internal Revenue Service Developments**

#### ***What are the current tax issues that may affect audits of health care organizations?***

.38 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 such failure 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 or an indirect effect on the financial statements that would require appropriate disclosures. In addition, intermediate sanctions allow the Internal Revenue Service (IRS) to monetarily penalize officers, directors, and other disqualified persons directly for their participation in excess benefit transactions. Although such a penalty would likely not materially affect financial statements, the excess-benefit transaction that triggers the penalty may require disclosure.

#### ***IRS Focus on Joint Ventures***

.39 Increasingly, tax-exempt hospitals have joined forces with for-profit entities to enlarge the resource base available with which to provide quality, low-cost health care to the public. In connection with joint

ventures of this type, concerns arise about whether a hospital could jeopardize its tax-exempt status or be subjected to the unrelated business income tax.

.40 The IRS has indicated that its Coordinated Examination Program (CEP), which involves audits of large, complex exempt organizations such as nonprofit hospitals, will focus more on such joint ventures between tax-exempt organizations and taxable entities. CEP audits will be a major component of the IRS Exempt Organizations Division's work plan for this fiscal year and likely for the next fiscal year as well.

.41 This is a follow-up to the IRS's release of Revenue Ruling 98-15, in which two situations involving whole hospital joint ventures between tax-exempt hospitals and taxable entities are discussed. According to the ruling, an Internal Revenue Code Section 501(c)(3) organization may form and participate in a partnership arrangement if—

1. Such participation furthers a charitable purpose.
2. The partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.

The central message of the ruling appears to be that the analysis is one of facts and circumstances; the fundamental issue is whether the exempt participant has sufficient control to ensure that the venture will be operated in an exempt manner and to prevent private inurement or impermissible private benefit.

### ***Proposed Regulation on Disclosure***

.42 Final regulations are being developed relating to tax-exempt organization disclosure requirements under Internal Revenue Code Section 6104(e), which requires exempt organizations to provide copies of their exemption applications and three most recent information returns on request. The new public inspection rules provide that—

1. Requests made in person must be responded to immediately.
2. Written requests must be responded to within thirty days.

Reasonable fees to cover administrative costs for postage and reproduction are permissible. Exceptions to this rule are provided if—

1. The documents are requested to harass an organization; however, the IRS has indicated that harassment campaigns probably will be "narrowly construed."
2. The documents are made "widely available" (that is, making materials available via electronic means, such as the Internet).

Failure to comply with the public inspection rules could result in a \$20-per-day penalty with a \$10,000 maximum, with a \$5,000 penalty for willful failure.

#### **Executive Summary—Internal Revenue Service Developments**

- Auditors should be aware of relevant tax laws and regulations to assess their potential effect on health care organizations and their financial statements. For example, 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 such failure could possibly require modification of the auditor's report.
- The IRS has indicated that its Coordinated Examination Program will focus more on joint ventures between tax-exempt organizations and taxable entities. Concerns arise in such arrangements about whether a hospital could jeopardize its tax-exempt status or be subjected to the unrelated business income tax.
- Final regulations are being developed relating to tax exempt organization disclosure requirements—they must provide copies of exemption applications and the three most recent information returns on request.



## Stark II Issues

.43 Effective January 1, 1995, the Limitations on Certain Physician Referrals law (the Stark Law) prohibits physicians from referring patients to health care organizations with which the physicians have a financial relationship for the furnishing of “designated health services” covered under Medicare or Medicaid. Although this legislation has been in effect for more than three years, little guidance has been available to the health care industry, particularly on the types of financial arrangements prohibited, the health care services covered under the statute, and how various statutory exceptions should be interpreted. On January 9, 1998, the Health Care Financing Administration (HCFA) issued proposed regulations likely to be of special interest to health care organizations, including the following:

- A physician furnishing services to a hospital as an employee or as an independent contractor cannot be required to refer patients to the hospital; otherwise, his or her compensation will impermissibly reflect the volume or value of referrals, even though payments from the hospital do not fluctuate in amount.
- A statutory requirement that leases and contracts for personal services have a contract term of at least one year does not preclude contract provisions permitting earlier contract termination for “good cause,” so long as the parties do not enter into another contract arrangement within the initial one-year period.
- There is an exception for hospitals’ payment of physician recruitment incentives; however, according to the proposed regulations, it protects only arrangements in which a physician residing outside a hospital’s geographic area relocates to join the hospital’s medical staff. Payments to a hospital resident or other physician living within the hospital’s geographic area are not protected under this exception.
- There is an exception for “in-office ancillary services,” such as physician office labs operated by physicians or “group practices”; however, according to the proposed regulations, a group practice member cannot be credited directly with revenues from designated health services he or she orders for a Medicare or Medicaid patient, even if the physician actually performs the service.

## Balanced Budget Act

*What are the significant provisions of the Balanced Budget Act of 1997 that will affect health care organizations in the current year?*

.44 The Balanced Budget Act of 1997 (BBA) has been characterized as having the greatest impact on the Medicare program since the inpatient prospective payment system was implemented in 1983. Overall, the federal government expects to reduce expenditures by \$116 billion over five years. The BBA has such a far-reaching impact that no providers are untouched. Although certain provisions do not take effect until 1999, several were implemented in 1998, and providers will soon be subject to the remaining provisions. The home health changes, for example, are so significant that certain providers may not continue to offer this service. Other provisions not only reduce reimbursement, but also may affect the way care is delivered. The following is a brief summary of certain of the more significant provisions whose impact will be felt during 1998.

### *Hospital Inpatients*

.45 For federal fiscal year 1998 (through September 30, 1998) payment rates for inpatient services were generally frozen at prior-year levels. Future annual updates are tied to health care inflation less 1 percent to 2 percent. The federal fiscal year 1999 (effective October 1, 1998) is estimated at 0.5 percent for most providers. Additionally, for ten Diagnosis-Related Groupings (DRGs), certain discharges from the inpatient setting to post-acute-care settings, such as home health or skilled nursing, are to be considered transfers rather than discharges. This provision, which is effective October 1, 1998, will affect reimbursement by reducing DRG payments to offset reimbursement to other providers, such as home health care or skilled nursing facilities. In addition, academic medical centers and teaching hospitals will see significant cuts in indirect medical education funding in federal fiscal year 1999, increasing each fiscal year until 2002.

### ***Skilled Nursing Facilities***

.46 Effective for cost-reporting periods beginning on or after July 1, 1998, a skilled nursing facility (SNF) prospective payment system (PPS) is to be implemented. SNF PPS rates, which will be phased in over three years, are to include all costs of furnishing covered SNF services (routine, ancillary, and capital-related costs). SNFs are also required to provide Medicare with consolidated billing, a comprehensive billing requirement (similar to the one in effect for inpatient hospital services for more than a decade) under which the SNF itself is responsible for billing Medicare for virtually all the services to its residents.

### ***Home Health***

.47 Home health services are to be covered by a PPS for years beginning on or after October 1, 1999. Payments under the PPS are the lesser of allowable costs, per-visit limits or per-beneficiary limits. The per-beneficiary limits in particular will have a very negative impact on reimbursement for agencies that treat complex patients requiring high levels of service.

### ***Hospital Outpatients***

.48 BBA introduced a PPS methodology for hospital outpatients. Beginning January 1, 1999, Medicare payments for outpatient services will be housed in this PPS, much like inpatient care is paid for today. All hospital departments will be covered except those already covered by another fee schedule (for example, ambulance, dialysis, and laboratory). Payments for services will include drugs, supplies, and operating room observation. The ambulatory payment classification (APC) system will be used to establish a distinct payment for each group of diagnosis or procedure circles. Because of year 2000 information system issues, the HCFA has announced it is delaying the implementation of an outpatient PPS methodology until after January 1, 2000.

### ***Other Hospital Provisions***

.49 The BBA also reduced Medicare reimbursement by eliminating the formula-driven overpayment for outpatient services.

## **Capital Risk Requirements for Managed Care Organizations**

### ***Risk-Based Capital Requirements***

.50 The risk-based capital (RBC) formula is one of the tools used by regulators to evaluate the financial health of regulated entities. It is a method of measuring the minimum amount of capital appropriate for a health care organization to support its overall business operations in consideration of its size, structure, and risk profile.

.51 The final National Association of Insurance Commissioners (NAIC) formula for managed care organizations (MCO), RBC was approved at the December 1997 NAIC meeting. Health care organizations will be required to report RBC results for the first time in their 1998 annual statements. Five principal risk elements to the MCO RBC formula are: affiliated investment risk, asset risk, underwriting risk, credit risk, and general business risk. Four action levels (in order of increasingly stringent level of regulatory response) are: company action level, regulatory action level, authorized control level, and mandatory control level. At a minimum, the company action-level event requires the filing with the respective state insurance commissioner an RBC plan detailing conditions leading to the event and proposals of corrective action.

### ***Codification of Statutory Accounting Principles for Managed Care Entities***

.52 In March 1998, the NAIC finalized the Codification of Statutory Accounting Principles (SAP) guidance, which will replace the current *Accounting Practices and Procedures* manual as the NAIC's primary

guidance on statutory accounting. The Codification provides guidance for areas in which statutory accounting has been silent and changes current statutory accounting in some areas; for example, deferred income taxes are recorded.

.53 The NAIC adopted a recommendation to state insurance departments that they adopt the Codification guidance as soon as possible, with an effective date of January 1, 2001. States may, however, elect effective dates before or after that date.

.54 Companies will not be required to follow the Codification guidance until it is adopted by the state of domicile. Until the state of domicile adopts the Codification, consideration should be given to disclosure in the financial statements prepared in conformity with generally accepted accounting principles (GAAP), if the effect of the adoption is expected to be material or in situations in which the client has not determined the effect of the Codification. In addition, practitioners should consider whether going-concern issues exist as a result of the financial statement effect of the adoption of Codification. This includes consideration of the effect on RBC.

.55 There are eight proposed Statements of Statutory Accounting Principles (SSAPs) for managed health care entities that have been specifically modified to address issues related to managed care. It is anticipated that all other SSAPs will apply if applicable to the entity. This could lead to significant changes in accounting for some companies, because statutory accounting guidance for health care organizations was silent in many areas.

## Audit Issues and Developments

### New SOP on Auditing Federal Awards Issued

*How will the new SOP 98-3 assist auditors in performing audits of federal awards?*

.56 As a result of the numerous changes in the single audit arena (described in the Regulatory, Legislative, and Other Developments section of this Alert), the AICPA has issued SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. The SOP provides auditors of states, local governments, and not-for-profit organizations with guidance relating to their responsibilities and reporting requirements in audits performed and corresponding reports issued under the Single Audit Act Amendments of 1996 and Circular A-133. In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, SOP 98-3—

- Describes the auditor's responsibility for testing and reporting on the financial statements and the schedule of expenditures of federal awards.
- Discusses various planning and other special audit considerations of Circular A-133, including establishing an understanding with the auditee, initial-year audit considerations, the additional requirements of *Government Auditing Standards*, and audit materiality considerations.
- Describes the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements under GAAS, *Government Auditing Standards*, and Circular A-133.
- Includes an entire chapter devoted to the determination of major programs and the risk-based approach.
- Describes the auditor's responsibility for reporting and provides illustrations of the reports required by *Government Auditing Standards* and Circular A-133.
- Describes the auditor's responsibility for testing and reporting in a program-specific audit and provides illustrations of the related reports.
- Includes an illustrative schedule of findings and questioned costs and illustrative schedules of expenditures of federal awards.

Further, the SOP incorporates guidance from the following documents:

- The Single Audit Act Amendments of 1996 and Circular A-133 (Both of these documents are included as appendixes to the SOP.)
- Various AICPA SASs, including SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801)
- *Government Auditing Standards* (1994 revision)
- The OMB Circular A-133, *Compliance Supplement* (June 1997 revision)

## Compliance With Medicare and Medicaid Laws and Regulations

.57 The government's recent focus on health care fraud and abuse, as previously discussed, has resulted in instances of fines and penalties that were material to the provider's financial statements, for violations of billing laws and regulations and violations of cost report reimbursement regulations. Many providers of service to Medicare have potential exposure to fines and penalties as a result of billing or cost reporting issues.

.58 A corporate compliance program (see the Regulatory, Legislative, and Other Developments section of this Alert) or similar controls are a component of a health care organization's internal control.

## Fraud and Abuse in the Health Care Industry

*What effect do the allegations of violations of laws and regulations in the health care industry have on this year's audits?*

.59 Allegations of violations of laws and government regulations continue to increase in virtually all sectors of the health care industry. The allegations concern violations of a wide variety of laws and regulations, such as the Medicare and Medicaid Anti-Kickback Statute, Limitations on Certain Physician Referrals (the Stark law), and the False Claims Act, among others. Penalties for violating the laws may include denial of otherwise valid Medicare and Medicaid claims, fines, and civil money penalties (for example, treble damages, plus \$5,000 to \$10,000 per claim) and exclusion from the Medicare and Medicaid programs.

.60 When auditing health care organizations, auditors should be alert to the possibility of illegal acts. SAS No. 54, *Illegal Acts by Clients*, prescribes the nature and extent of the consideration that auditors should give to the possibility of illegal acts by a client in audits of financial statements in accordance with GAAS and provides guidance on the auditor's responsibilities when a possible illegal act is detected. The AICPA Audit and Accounting Guide *Health Care Organizations* further describes the application of SAS No. 54 in audits of financial statements of health care organizations.

## Audit Procedures

.61 SAS No. 54 notes that even in the absence of evidence concerning illegal acts, auditors should make certain inquiries of management about such matters as the client's policies relative to the prevention of illegal acts, the use of directives issued by the client, and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations. (Refer to the discussion titled Corporate Compliance, in the Regulatory, Legislative, and Other Developments section of this Audit Risk Alert for additional information.) Certain procedures, although not specifically designed to detect illegal acts, may bring possible illegal acts to an auditor's attention. Such procedures include reading minutes of board of directors meetings; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; or performing substantive tests of details of transactions or balances. These considerations take on increasing importance when conditions such as those currently encountered in the health care industry exist.

.62 Pursuant to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), auditors ordinarily obtain written representations from management concerning the absence of 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. Given the increase in allegations of violations of laws and government regulations in the health care industry, the auditor may consider obtaining additional representations relating to, for example, management's knowledge of potential fraud and abuse violations. Some of the representations that the auditor might consider obtaining include the following:

- Receivables
  - Adequate provision has been made for estimated adjustments to revenue, such as for denied claims, changes to (DRG) assignments, and cost-report audits.
  - Recorded reserves are necessary, appropriate, and properly supported.
  - All peer review organizations, fiscal intermediary, and third-party payer reports and information have been made available.
  - All required Medicare, Medicaid, and similar reports have been properly filed.
  - Appropriate provision has been made for audit adjustments by intermediaries, third-party payers, or other regulatory agencies.
- Contingencies
  - There are no violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes, including but not limited to the Medicare and Medicaid Anti-Kickback Statute, Limitations on Certain Physician Referrals (the Stark law), and the False Claims Act, in any jurisdiction whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency other than those disclosed or accrued in the financial statements.
  - Billings to third-party payers comply in all respects with applicable coding principles and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse), and reflect charges only for goods and services that were medically necessary; properly approved by regulatory bodies (for example, the Food and Drug Administration), if required; and properly rendered.
  - There have been no communications (oral or written) from regulatory agencies, governmental representatives, employees, or others concerning investigations or allegations of noncompliance with laws and regulations in any jurisdiction (including those related to the Medicare and Medicaid antifraud and abuse statutes), deficiencies in financial reporting practices, or other matters that could have a material adverse effect on the financial statements.

In addition, auditors should refer to the guidance in SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333).

.63 SAS No. 54 also provides guidance on auditors' responsibilities if specific information concerning a possible illegal act comes to their attention. The SAS states that when the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implication for other aspects of the audit.

.64 When such circumstances occur, evaluating the adequacy of accrual for or disclosure of the potential effects of illegal acts in the financial statements of health care organizations is a matter that is likely to require a high level of professional judgment.

.65 Because of the complex nature of Medicare and Medicaid laws and because such laws are subject to interpretation, auditors should suggest that health care organizations with material amounts of Medicare or Medicaid revenues disclose the significance of such revenues (in dollars or percentages) and describe the com-

plex nature of applicable laws and regulations. They might also consider suggesting that the financial statements state management's belief that they are in compliance with the applicable laws and regulations, but indicate that the possibility of future government review and interpretation exists.

.66 If investigations of alleged illegal acts are currently in process, or if claims have been threatened or asserted, additional disclosures may be required by FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59). Auditors also may want to consider whether, in view of the far-reaching nature of alleged violations of laws and regulations in the health care industry, the disclosure requirements of SOP 94-6, *Disclosures of Certain Significant Risks and Uncertainties*, have been met.

.67 Representations from legal counsel are often key audit evidence. The inability of an attorney to form an opinion on matters about which he or she has been consulted may be indicative of an uncertainty that should be disclosed in the financial statements in accordance with FASB Statement No. 5 or SOP 94-6. SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), states that if the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor should express a qualified or an adverse opinion. Such judgments should be made in the context of the financial statements taken as a whole and in light of the surrounding circumstances. When considering procedures for identifying litigation, claims, and assessments and for the financial accounting and reporting for such matters when performing an audit in accordance with GAAS, auditors should refer to the guidance set forth in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).

### ***Reporting to the Government***

.68 Instances have been noted in practice in which officials of various federal regulatory agencies (such as assistant inspectors general) have indicated that auditors have an obligation to report any identified illegal acts directly to the inspectors general or other regulatory officials. In evaluating their responsibilities in response to such requests, auditors should consider the guidance in paragraph 23 of SAS No. 54, which provides guidance on disclosure of an illegal act to parties other than the client's senior management and its audit committee, and consult with their legal counsel.

#### **Executive Summary—Fraud and Abuse in the Health Care Industry**

- Allegations of violation of laws and governmental regulations continue throughout the health care industry concerning the Medicare and Medicaid Anti-Kickback Statute, Limitations on Certain Physician Referrals, and the False Claims Act, among others. Thus, auditors should be aware of their responsibilities pursuant to SAS No. 54, *Illegal Acts by Clients*.
- Obtaining representations from the client's management and from legal counsel may be especially important in the current environment. Auditors should consider the guidance set forth in SAS No. 85, *Management Representations*, and SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.

### **Obligated Group Financial Statements**

#### ***Can obligated group financial statements be included in a public offering?***

.69 *Obligated group* is a term used to denote a group of entities, sometimes a parent corporation and several of its subsidiaries, that is liable for the repayment of an obligation, such as a tax-exempt bond. Financial information related to the obligated group is useful to the owner of the debt instrument. Obligated group financial statements often exclude entities that are required to be consolidated by GAAP. Such financial statements cannot be used as the reporting entity's general-purpose financial statements because they are

not prepared in accordance with GAAP. They may, however, be issued as special-purpose financial statements with distribution limited to specified users (that is, the company and other parties to the debt agreement). It would not be appropriate to include such special-purpose financial statements in a public offering (see Interpretation No. 13, "Reporting on a Special-Purpose Financial Statement That Results in an Incomplete Presentation But Is Otherwise in Conformity With Generally Accepted Accounting Principles," of SAS No. 62, *Special Reports* [AICPA, *Professional Standards*, vol. 1, AU sec. 9623.80–.81]).

.70 With respect to public offerings, two alternatives are available to auditors:

1. The auditor may opine on consolidated financial statements and include supplementary consolidating financial information that displays totals for the obligated group. Because the consolidated financial statements include all entities required to be consolidated under GAAP, the auditor's report on the consolidated statements need not be limited in its distribution.
2. The auditor may opine on the consolidated financial statements that are included as an appendix in the public offering, with management providing an unaudited reconciliation of the amounts in the obligated group financial statements to the audited consolidated financial statements.

## New Auditing Pronouncements

### SAS No. 86

.71 In March 1998, the Auditing Standards Board (ASB) issued SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), to reflect the March issuance of Statement on Standards for Attestation Engagements (SSAE) No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SSAE No. 8 provides guidance on the performance of examinations and reviews of management's discussion and analysis (MD&A) prepared pursuant to the SEC's rules and regulations. SAS No. 86 allows practitioners that have examined or reviewed MD&A in accordance with SSAE No. 8 to state that fact in the introductory section of the comfort letter and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

### SAS No. 87

.72 In September 1998, the ASB issued SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), which is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The SAS states that an auditor should restrict the use of a report in the following circumstances:

1. The subject matter of the auditor's report, or the presentation being reported on, is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or other comprehensive basis of accounting (OCBOA).
2. The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
3. The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

In addition to describing the circumstances in which the use of an auditor's report should be restricted, the Statement, among other things, defines the terms *general use* and *restricted use*, specifies the language to be

used in restricted-use reports, and requires an auditor to restrict a "combined" report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

.73 Both the report on compliance and internal control over financial reporting issued by the auditor in an audit of financial statements performed in accordance with *Government Auditing Standards* and the report issued on compliance and internal control over compliance in a Circular A-133 audit are considered restricted-use reports. Auditors of health care organizations for whom such reports must be issued should consider the provisions of SAS No. 87.

.74 For information on other auditing pronouncements issued this year, see the *Audit Risk Alert—1998/99* [AAM section 8010].

## Year 2000 Issues

### *What is the Year 2000 Issue? How will it affect health care organizations?*

.75 The Year 2000 Issue relates to the inability of many electronic data processing systems to accurately process year-date data beyond the year 1999. This is because the majority of computer programs in use today have been designed to store dates in the dd/mm/yy (date/month/year) format, thus allowing only two digits for each date component. So, for example, the date December 31, 1998, is stored in most computers as "12/31/98." Inherent in programming for dates in this manner is the assumption that the designation "98" refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit-year input fields will cause many computers to treat the entry "00" as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00), as January 1, 1900, and process that data incorrectly, or perhaps not at all.

.76 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year 2000 ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur this year. For example, some software programs may have assigned special meanings to date entries coded "xx/xx/98" or "xx/xx/99" to allow for the testing of software modifications. Therefore, actual transactions using such dates may not be processed correctly or stop functioning. Failures may take place currently when systems perform calculations into or beyond the year 2000.

.77 Health care organizations face unique year 2000 issues that may affect the entire organization, not just those departments that are affected by information technology. Although the Year 2000 Issue may seem more likely to affect areas relating to information processing, such as patient accounting—that is, invoice dates, dates of services, billing and due dates, and aging—problems could also arise that compromise patient care, disrupt business functions, and increase exposure to business and legal risks. To complicate matters, the health care industry's year 2000 readiness efforts appear to be significantly behind those of other industry groups. Recent research suggests that almost two-thirds of health care organizations have not yet started to address the Year 2000 Issue, and hospitals in particular are behind. Those organizations that have started appear to be in the early stages of addressing the issue.

.78 The Year 2000 Issue is also a concern to federal regulators. For example, the HCFA is warning Medicare contractors to become year 2000 ready by 1999 or face losing their Medicare business. The HCFA is establishing guidelines to contractors for intended year 2000 remediation plans.

.79 Among the factors that pose significant, unique risks for health care organizations are the following:



- The Year 2000 Issue is not necessarily limited to computers but may extend to medical devices with imbedded computer chips that are date-sensitive. Such equipment could include life-saving mechanisms, such as heart defibrillators, pacemakers, and intravenous pumps.<sup>1</sup> Though it is estimated that less than 20 percent of such equipment may have year 2000 problems, they must nevertheless be inventoried and assessed.
- Health care organizations will have to make sure that vendor-supplied software is year 2000 ready. This problem is likely to be particularly acute, given that approximately 70 percent to 80 percent of computer software used by health care organizations is developed by third-party vendors. Remediation of such software may be beyond the control of internal information technology staff. As such, there will be heavy reliance on outside vendors to provide information technology solutions. The risk is therefore greater that health care organizations will be exposed to a vendor's failure to support installed versions of a product or applications.
- Financial pressures related to consolidation and regulation in the insurance and health care industry are putting pressure on information-technology budgets, thus limiting the resources available to address the Year 2000 Issue.
- Many health care organizations make extensive use of the electronic exchange of information and payments with insurers and claims processors, physician practices, and affiliated organizations, raising the risks of external contamination as well as the effort associated with ensuring that these external interfaces are all documented and year 2000 ready.
- As hospitals move toward "just-in-time" computerized delivery systems, supply-chain year 2000 readiness must be assessed and appropriate contingency plans put in place, because vital supplies, goods, and services come from businesses outside of the health care organization. Assessments must extend beyond distributors to materials manufacturers.

Auditors should be aware of the many auditing and accounting issues that arise from the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. A more comprehensive discussion of this topic can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

.80 In addition, Internet Web sites that might provide useful year 2000 information to auditors include the following:

- <http://www.Rx2000.org>—Rx2000 Solutions Institute, health care's year 2000 information clearing-house
- <http://www.hcfa.gov>—the HCFA's Web site
- <http://www.aicpa.org>—the AICPA's Web site
- <http://www.sec.gov>—Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers
- <http://www.y2kgov.au/biomed/index.html>—Biomedical Database, sponsored by the Australian government

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<sup>1</sup> An independent project is being conducted to develop a shared database that assesses the potential impact of the Year 2000 Issue on the proper functioning of certain medical devices. The study divides medical devices into three categories: those with no reliance on dates, those with date reliance that is not expected to affect the operation of the device, and those with date reliance that could be affected by the Year 2000 Issue. The results data have been provided by different hospitals and primary owners of such data with the intent to share this information with others in the health care field. Further information can be obtained by calling (212) 539-3072.

**Executive Summary—Year 2000 Issues**

- Unless corrective actions are taken, the Year 2000 Issue may cause accounting and financial information systems to produce inaccurate date-related output. Certain problems could arise during 1998 and 1999.
- Year 2000 failures may affect more than just patient accounting. Health care organizations may see disruptions in patient care, as well.
- Health care organizations may be exposed to risks with medical equipment containing imbedded computer chips that are date sensitive, with vendor-supplied software for which no support is available, and with electronic information exchange that is not year 2000 ready.
- Many auditing and accounting issues arise from the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. A more comprehensive discussion of this topic can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

**Accounting Issues and Developments**

*What are the recently issued auditing and accounting pronouncements affecting health care organizations?*

**Newly Issued SOPs*****Joint Activities***

.81 In March 1998, the AICPA issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*. The SOP applies to not-for-profit organizations and state and local governmental entities in determining fund-raising costs. It supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, and amends existing guidance in the *Audit and Accounting Guide Health Care Organizations* (as well as the *Not-for-Profit* and *State and Local* Guides). SOP 98-2 requires entities to report as fund-raising costs the costs of all materials and activities that include a fund-raising appeal. These costs include those 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 each met, subject to the following exception. Costs of goods or services provided in exchange transactions, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fund raising. If the criteria of purpose, audience, and content are met, the joint costs of those activities should be allocated and costs that are clearly identifiable with fund-raising, program, or management and general functions should be charged to those cost objectives.

.82 SOP 98-2 applies to all nongovernmental not-for-profit organizations and all state and local governmental entities that solicit contributions and is effective for years beginning on or after December 15, 1998. Some entities will undoubtedly change the way they conduct their activities to meet the allocation criteria. The lead time on conducting such activities can be as long as six months. Auditors should discuss the SOP with their clients and start reviewing their activities now to plan for implementation of the SOP.

.83 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.

.84 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.

.85 Not-for-profit health care organizations and auditors should carefully review the requirements of the applicable SOP and consider the sufficiency of evidence that exists to support any allocations of such joint costs.

### ***Internal Use Software***

.86 In March 1998, Accounting Standards Executive Committee (AcSEC) issued SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. The SOP requires that entities capitalize certain internal-use software costs once certain criteria are met. The SOP identifies the characteristics of internal-use software and provides examples to assist in determining whether computer software is for internal use. The SOP applies to all nongovernmental entities and is effective for financial statements for fiscal years beginning after December 15, 1998, though earlier adoption is encouraged.

### ***Start-Up Activities***

.87 In April 1998, AcSEC issued SOP 98-5, *Reporting on the Costs of Start-Up Activities*. The SOP requires that entities expense the costs of start-up activities and organization costs as incurred. The SOP broadly defines start-up activities and provides examples, including an example specific to not-for-profit organizations, to help entities determine what costs are and are not within the scope of the SOP. The SOP applies to all nongovernmental entities and, except for certain investment companies, is generally effective for financial statements for fiscal years beginning after December 15, 1998, though earlier adoption is encouraged.

## **SEC Issues and Developments**

*What are some issues of concern this year for health care organizations subject to SEC regulations?*

### ***Goodwill Lives***

.88 The SEC staff continues its scrutiny of goodwill lives, both for initial and existing registrants, as well as registrants with business combinations accounted for as purchases and those that have recently experienced significant events, such as a writeoff of goodwill, a major restructuring, a history of recent losses or the sale of a division at a loss. Although the SEC staff has not objected to longer-term amortization periods in certain circumstances, amortization periods of twenty-five years or less are often appropriate. Accordingly, health care organizations should be prepared specifically to support their assertion of long-term lives and should conduct a continuing assessment of initial and remaining goodwill lives. Some factors to consider when assessing initial and remaining goodwill lives include—

- Increased competition and industry consolidation.
- Changing third-party reimbursement requirements.
- Technological medical innovation.
- Employment agreements with key operating personnel or relationships with key operating personnel.
- Changing regulatory environment.

Additionally, health care organizations should be aware that the use of a “blended life” for goodwill and other intangible assets of fifteen to twenty-five years, resulting from the “blending” of goodwill with a life of forty years and other shorter-lived intangibles, is generally not supportable. APB Opinion 16, *Business Combinations*, requires that identifiable assets be separately valued and amortized.

.89 The SEC has recently focused considerable attention on amortization periods for goodwill and management services agreement (MSA) intangibles recorded by physician practice management companies. Their most recent reviews were put forward on July 27, 1998, when a member of the SEC staff spoke at the AICPA's National HealthCare Industry Conference. In a speech on physician practice management (PPM) accounting and reporting matters, the SEC staff member noted that:

PPMs with current amortization periods in excess of 25 years should reevaluate their amortization policy immediately and change to a shorter amortization period. While the staff believes the use of periods exceeding 25 years may have been an error in the application of GAAP, it will not object if registrants conclude that the effects should be reported as a change in estimate (as opposed to correction of an error) prospectively over the remaining revised period.

While these remarks are not binding on the SEC, PPMs should consider the necessity of conducting a thorough, continuing assessment of the lives of their recorded goodwill, MSA intangibles and other intangible assets. Factors unique to PPMs that may be considered include—

- Ability of a management company and the medical practices to perform under the terms of a service arrangement over an extended period.
- Ability to continue revenues upon departure of key owners or physicians of the practice.
- Term(s) of employment contracts with key owners or physicians.
- Revised incentive structures.
- Ability to withstand legal challenges concerning the corporate practice of medicine.

### ***Accounting and Disclosure by Physician Practice Management Companies***

.90 The SEC staff has issued a number of informal views on PPM accounting and reporting issues.

.91 **Financial Issues.** During the consideration of the FASB Emerging Issues Task Force (EITF) Issue No. 97-2, *Accounting and Disclosure by Physician Practice Management Companies*, the SEC staff did not object to the following: The revenues and expenses of the medical practice could be displayed in the PPM's statement of operations if the management agreement terms provide the PPM with a net profits or equivalent interest in the preponderance of the medical services furnished by the medical group. A net-profits interest arises when the management fee is derived from the profit of the medical practice.

.92 If the revenue and expenses of the medical practice are displayed in the PPM's financial statements, they must be disclosed separately on the face or in the notes. Management fee and lease income from the medical group should also be disclosed. Actual aggregate management fee income and selling general and administrative costs of the PPM must be clearly disclosed on the face of the statement of operations with note disclosure of the material contract terms bearing on their calculation. After compliance with EITF Issue No. 97-2 is required, the staff will object to the continued display of revenues and expenses of the medical practice in this manner.

.93 **Separate Financial Statements of the Medical Practices.** If the PPM is expected to have a material dependence on the medical practice, separate financial information about the practice would be material to investors. The SEC staff has accepted unaudited summary financial information for the three most recent fiscal years if audited financial statements are not readily available and its owners are not significant shareholders or promoters of the PPM. Also, if a PPM guarantees a practice's income, extends unusual credit terms, funds operating losses, or otherwise provides loans to the practice, separate financial information about that practice would be material to investors. Disclosure issues include the following:

- Business and contractual relationships should be clearly and accurately described by the offering documents and ongoing reports.

- The nature of the PPM's business and relationship to the medical practice should be included (cover topics such as contractual relationships, how PPM fees are determined, whether management fee agreements are subject to adjustment, and loan arrangements between the PPM and the medical practice).
- PPM's relationship with care providers and payors should be described (description of contracts, who bears risk, whether or not there are regulatory considerations).
- State or federal regulations applicable to the PPM should be described (including corporate practice of medicine laws, antikickback and self-referral restrictions).
- Management discussion and analysis should discuss financial terms of the management contracts and detailed disclosure of individually material agreements.
- Acquisition agreements and material management agreements should be filed.

#### **EITF Issue No. 97-2**

.94 The EITF recently has considered matters relating to financial statement preparation as Issue No. 97-2, *Accounting and Disclosure by Physician Practice Management Companies*. On November 30, 1997, the EITF reached consensus on the various issues embodied in the Issue No. 97-2 project. Transition guidance was established in March 1998.

.95 The Issue provides a list of criteria which, when applied to contractual arrangements between PPMs and medical practices, indicate whether the PPM should consolidate the assets and operations of the medical practice. If a contractual arrangement meets all the criteria, the PPM must consolidate the physician practice(s). Conversely, if a single area is not met, the PPM cannot consolidate the physician practice(s). The EITF concluded that when a PPM acquires the net assets and enters into long-term management service agreements with the medical entity, rather than acquiring the medical entity's stock outright, it should be considered an APB Opinion 16 business combination accounted for as a purchase if the medical entity is "a business" (this should be based on facts and circumstances), and the PPM is required to consolidate the medical entity. This acquisition cannot be accounted for as a pooling of interest. If the consolidation criteria are not met or the physician practice is not a business, the management agreement should be accounted for as a service contract.

.96 If a PPM consolidates the physician practice, the physicians or dentists employed by the practice would be considered as employees of the PPM issuing stock options. If not, the physicians and dentists would not be considered employees. In such cases, the accounting treatment for nonemployee options under FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FASB, *Current Text*, vol. 1, sec. C36), would be required.

.97 **Transition Guidance.** The transition guidance provided in EITF Issue No. 97-2 is extensive and complex and therefore should be read in its entirety.

#### **Executive Summary—Securities and Exchange Commission Issues and Developments**

- The SEC staff continues its scrutiny of goodwill lives for both initial and existing registrants, and accordingly could be an area of greater audit risk this year.
- The SEC staff has issued a number of informal views on physician practice management companies relating to financial and disclosure issues.
- Accounting and disclosure by physician practice management companies have also been considered by the FASB's EITF in Issue No. 97-2.

## Proposed SOP on Certain Managed Care Arrangements

.98 AcSEC has undertaken a project on accounting for certain managed care arrangements. The proposed SOP would affect both entities following the insurance model (FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* [FASB, *Current Text*, vol. 2, sec. In6]) and entities following the health care model (AICPA Audit and Accounting Guide *Health Care Organizations*, which incorporates SOP 89-5, *Financial Accounting and Reporting by Providers of Prepaid Health Care Services*). The SOP will likely amend *Health Care Organizations* and may amend the AICPA Audit and Accounting Guide *Audits of Stock Life Insurance Companies*. The SOP would apply to all nongovernmental entities, and potentially to certain governmental entities, undertaking managed care transactions.

.99 The project addresses the following issues:

- *Bifurcation*. Should revenues be bifurcated between premiums and administrative fees? If so, how?
- *Reinsurance*. Should reinsurance transactions be presented gross or net in the income statement?
- *Accounting for loss contracts*. For purposes of determining whether a premium deficiency exists, should contracts be grouped? If so, how? How should costs that do not vary with a contract or group of contracts be treated? Should anticipated investment income be considered?
- *Incurred-but-not-reported (IBNR) claims*. How should IBNR claims be determined?
- *Deferred acquisition costs*. Should acquisition costs be capitalized? If so, which costs should be eligible for capitalization?

AcSEC expects to release an exposure draft of a proposed SOP for public comment in the first quarter of 1999.

## Accounting for Derivatives

.100 Issued in June 1998, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50), establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (2) a hedge of the exposure to variable cash flows of a forecasted transaction; or (3) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.101 FASB Statement No. 133 applies to all entities. A not-for-profit organization should recognize the change in fair value of all derivatives as a change in net assets in the period of the change. In a fair value hedge, the changes in the fair value of the hedged item attributable to the risk being hedged also are recognized. However, because of the format of their statement of financial performance, not-for-profit organizations are not permitted special hedge accounting for derivatives used to hedge forecasted transactions. FASB Statement No. 133 does not address how a not-for-profit organization should determine the components of an operating measure if one is presented.

.102 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It supersedes FASB Statements No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB State-

ment No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. FASB Statement No. 133 also nullifies or modifies the consensus reached in a number of issues addressed by the EITF.

.103 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

.104 For a comprehensive summary of accounting pronouncements issued this year, see the *Audit Risk Alert*—1998/99 [AAM section 8010].

## AICPA Audit and Accounting Literature

*What other AICPA publications can be of value to auditors of health care organizations?*

### Audit and Accounting Guide

.105 The AICPA Audit and Accounting Guide *Health Care Organizations* (Product No. 012438), 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 (888) 777-7077 or faxing a request to (800) 362-5066.

### Health Care Financial Reporting Checklist

.106 The AICPA's Accounting and Auditing Publications Division has published a revised version of the *Checklists and Illustrative Financial Statements for Health Care Organizations* (Product No. 008722), 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 (888) 777-7077 or faxing a request to (800) 362-5066.

### Technical Practice Aids Publication

.107 *AICPA Technical Practice Aids* includes questions received by the AICPA's Technical Hotline 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 (Product No. G01013) and in paperback form (Product No. 005058). Copies may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066.

### National Health Care Conference

.108 Each summer the AICPA and the Health Care Financial Management Association cosponsor a National Health Care Conference that is specifically designed to update auditors and health care financial executives on significant accounting, legal, financial, and tax developments affecting the health care industry. Information on the conference may be obtained by calling the AICPA Conferences Division at (201) 938-3556.

### Continuing Professional Education

.109 The AICPA offers the following group-study courses:

- Advising Doctors on Practice-Related Agreements in a Managed Care Environment
- Fraud in the Health Care Industry
- Health Care Industry and Medical Practice Valuation
- Managed Care Issues Into the Next Century—What the CPA Needs to Know
- Optimizing Medicare Reimbursement for Skilled Nursing Facilities
- Preparing the Medicare Cost Report for Skilled Nursing Facilities

.110 The AICPA offers the following self-study courses:

- Doctors' Practice-Related Agreements (Product No. 732031JK)
- Fraud in the Health Care Industry (Product No. 735205JK)
- Medicare Payment Systems (Product No. 739010JK)

## References for Additional Guidance

.111 This Alert contains a listing of publications pertaining to health care industry trends and statistics that may be of interest to auditors of health care organizations (see the table at the end of this Alert titled Information Sources). 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 publications or organizations. Many nongovernment and some government publications and services involve a charge or membership requirement.

.112 Fax services allow users to follow voice cues and request selected documents to 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.

.113 Electronic bulletin board services and Web sites 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.

.114 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.115 All phone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines.

.116 This Audit Risk Alert replaces *Health Care Industry Developments—1997/98*.

.117 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—1998/99* [AAM section 8010].

.118 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066. 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.

.119 Copies of federal documents referred to in this document are available for sale from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20401; order desk telephone: (202) 783-3238; fax: (202) 512-2250.



.120 The Health Care Industry Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may mail these comments to [Gdietz@aicpa.org](mailto:Gdietz@aicpa.org) or write to:

George Dietz, CPA  
AICPA  
Harborside Financial Center  
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Jersey City, NJ 07311-3881

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## Appendix

### Applicable Authoritative Guidance for Health Care Organizations

In recent years, the AICPA, the Financial Accounting Standards Board (FASB), 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 roadmap to applicable guidance for various accounting and reporting issues facing investor-owned, not-for-profit, and governmental health care organizations.

In January 1992, the AICPA issued 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), which redefined the generally accepted accounting principles (GAAP) hierarchy. SAS No. 69 describes the sources of established accounting principles for governmental entities and nongovernmental entities and how these sources relate to the new GAAP hierarchy.

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*, which clarifies how FASB statements affect governmental entities that use business-type accounting and financial reporting. In all cases, governmental health care organizations are required to follow GASB pronouncements unless excluded from the scope of a particular pronouncement. GASB Statement No. 20 provides two alternatives for FASB pronouncements. Under the first, governmental health care organizations should apply FASB pronouncements (and those of its predecessors, such as the Accounting Principles Board [APB]) issued through November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. Under the second alternative, organizations may also elect to apply FASB pronouncements issued after that date, again, provided that they do not conflict with or contradict GASB pronouncements. Either alternative must be used consistently and disclosed in the summary of significant accounting policies note to the financial statements.

An entity meeting the definition of a governmental organization as defined in paragraph 1.02 of the AICPA Audit and Accounting Guide *Health Care Organizations* is subject to the rules promulgated by the GASB. The following matrix illustrates how an organization's classification as investor-owned, not-for-profit, or governmental determines the appropriate authoritative guidance to be applied to various accounting and reporting issues.

Area	Investor-Owned	Not-for-Profit	Government
Reporting Entity	Accounting Principles Board (APB) Opinion 18, <i>The Equity Method of Accounting for Investments in Common Stock</i> (FASB, <i>Current Text</i> , vol. 1, sec. I82), and FASB Statement No. 94, <i>Consolidation of All Majority-Owned Subsidiaries</i> (FASB, <i>Current Text</i> , vol. 1, sec. C51)	AICPA Statement of Position (SOP) 94-3, <i>Reporting of Related Entities by Not-for-Profit Organizations</i>	GASB Statement No. 14

(continued)

Area	Investor-Owned	Not-for-Profit	Government
Contributions and Financial Statement Display	FASB Statement No. 116, <i>Accounting for Contributions Received and Contributions Made</i> (FASB, <i>Current Text</i> , vol. 1, sec. C67)	FASB Statement No. 116 and FASB Statement No. 117, <i>Financial Statement of Not-for-Profit Organizations</i>	GASB Statement No. 29 prohibits following FASB Statement Nos. 116 and 117; NCGAS 2, <i>Grant, Entitlement and Shared Revenue Accounting by State and Local Governments</i>
Cash Flows	FASB Statement No. 95, <i>Statement of Cash Flows</i> (FASB, <i>Current Text</i> , vol. 1, sec. C25)	FASB Statement No. 95	GASB Statement No. 9
Deposits with Financial Institutions	FASB Statement No. 105, <i>Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk</i> (FASB, <i>Current Text</i> , vol. 1, sec. F25)	FASB Statement No. 105	GASB Statement No. 3
Investments	FASB Statement No. 115, <i>Accounting for Certain Investments in Debt and Equity Securities</i> (FASB, <i>Current Text</i> , vol. 1, sec. I80), and Audit and Accounting Guide <i>Health Care Organizations</i> (the Guide), chapter 4	FASB Statement No. 124, <i>Accounting for Certain Investments Held by Not-for-Profit Organizations</i> (FASB, <i>Current Text</i> , vol. 2, sec. No5), and the Guide, chapter 4	GASB Statement No. 31; GASB Statement No. 3; GASB Statement No. 28; TB 94-1
Operating Leases	FASB Statement No. 13, <i>Accounting for Leases</i> (FASB, <i>Current Text</i> , vol. 1, sec. L10)	FASB Statement No. 13	GASB Statement No. 13
Prepaid Healthcare Arrangements and Self-Insurance Programs	The Guide, chapters 8 and 14	The Guide, chapters 8 and 14	GASB Statement No. 10 as amended by GASB Statement No. 30; the Guide, chapter 14, if following the "FASB Option" provided in paragraph 7 of GASB Statement No. 20
Compensated Absences	FASB Statement No. 43, <i>Accounting for Compensated Absences</i> (FASB, <i>Current Text</i> , vol. 1, sec. C44), and FASB Statement No. 112, <i>Employers' Accounting for Postemployment Benefits</i> (FASB, <i>Current Text</i> , vol. 1, various sections)	FASB Statement Nos. 43 and 112	GASB Statement No. 16

(continued)

Area	Investor-Owned	Not-for-Profit	Government
Debt Refundings	APB Opinion 26, <i>Early Extinguishment of Debt</i> (FASB, <i>Current Text</i> , vol. 1, sec. L35), FASB Statement No. 4, <i>Reporting Gains and Losses from Extinguishment of Debt</i> (FASB, <i>Current Text</i> , vol. 1, sec. I17), and FASB Statement No. 125, <i>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities</i> (FASB, <i>Current Text</i> , vol. 1, secs. F35 and F38)	APB Opinion 26 and FASB Statement Nos. 4 and 125	GASB Statement Nos. 7 and 23
Pensions	FASB Statement No. 87, <i>Employers' Accounting for Pensions</i> (FASB, <i>Current Text</i> , vol. 1, sec. P16), and FASB Statement No. 132, <i>Employers' Disclosures about Pensions and Other Postretirement Benefits</i> (FASB, <i>Current Text</i> , vol. 1, secs. P16, P40)	FASB Statement No. 87	GASB Statement No. 27
Risks and Uncertainties	AICPA SOP 94-6, <i>Disclosure of Certain Significant Risks and Uncertainties</i>	AICPA SOP 94-6	GASB Statements Nos. 10 and 30
Post Retirement Benefits	FASB Statement No. 106, <i>Employers' Accounting for Postretirement Benefits Other Than Pensions</i> (FASB, <i>Current Text</i> , vol. 1, sec. P40)	FASB Statement No. 106	GASB Statement No. 12 supplemented by GASB Statement No. 27

The Audit Risk Alert *State and Local Governmental Developments—1998* [AAM section 8070] includes a discussion of recently released GASB accounting pronouncements and projects. That Audit Risk Alert also contains valuable information on current issues and audit risks facing governmental organizations.

## 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 Health Care 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, Fourth 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
Health Care Financial Management Association (HFMA)	Order Department Two Westbrook Corporate Center, Suite 700 Westchester, IL 60154 (202) 296-2920	Fax-on-Demand (800) 839-HFMA	Health Care Financial Management (monthly publication) Issue Analysis 98-1, Compliance with Laws and Regulations for Health Care Organizations

(Continued)

## Information Sources (cont'd)

Organization	General Information	Fax Services	Web Site Address/ Electronic Bulletin Board	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077  Information about the AICPA's continuing professional education program is available through the AICPA Professional Development Team at (888) 777-7077, menu item 1.	24 Hour Fax Hotline (201) 938-3787	www.aicpa.org	
Financial Accounting Standards Board	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	24 Hour Fax on Demand (203) 847-0700, menu item 14	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)		www.gao.gov The Federal Bulletin Board includes Federal Register notices and the Code of Federal Regulations. Users are expected to open a deposit account. User assistance line: (202) 512-1530, (202) 512-1387(d) Telnet via Internet: federal.bbs.gpo.gov 3001	
U.S. Securities and Exchange Commission	Publications Unit 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 SEC Public Reference Room (202) 942-8079	Information Line (202) 942-8088, ext 4 (202) 942-7114	www.sec.gov	
U.S. Office of Management and Budget	Office of Administration Publications Office Room 2200 New Executive Office Bldg. Washington, DC 20503 (202) 395-7332	Information Line (202) 395-9068	www.whitehouse.gov/WH/EOP/ OMB/html/ombhome.html	

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[The next page is 8121.]

# AAM Section 8040

## *Insurance Industry Developments—1998/99*

### In This Year's Alert . . .

- Are there any special concerns currently about an insurer's investment?
- How and why are some mutual insurance companies restructuring?
- What should auditors be aware of during merger and acquisition activity?
- What are some matters affecting property and casualty insurers?
- What are some matters affecting life and health insurers?
- What new regulatory developments have occurred in the insurance industry?
- What should an auditor know about reinsurance arrangements?
- Do conditions exist that make liabilities for unpaid claims a high-risk audit area?
- What are some matters an auditor should be on the lookout for concerning surplus enhancement?
- Are there special concerns this year related to investments in hedge funds?
- When an insurance company invests in derivatives, what should an auditor be concerned with?
- Will international accounting standards for insurance companies be developed?
- What is the Year 2000 issue and how will it affect insurance companies?
- If an insurance company uses "permitted accounting practices," what guidance should an auditor follow?
- What new auditing and attestation standards have been issued?
- What new accounting developments have occurred?
- What are some organizations that can provide more information about the insurance industry?

\* \* \* \*

### Industry and Economic Developments

.01 The insurance industry may categorize 1998 as an eventful year. The robust stock market has been beneficial to the insurance industry for the first part of 1998; however, recent uncertainty in the U.S. stock market and in global markets has raised serious concerns about the future health of the market and the economy. Because the assets of an insurance company consist mainly of investments, which include bonds, stocks, mortgage loans, and real estate, fluctuations in the bond and stock markets have an indirect effect on an insurance enterprise's investment income, comprehensive income, and surplus. For an overall review of the performance of the U.S. economy, read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. This publication can be obtained by calling the AICPA Order Department at (888) 777-7077.

## Investments

### *Are there any special concerns currently about an insurer's investments?*

.02 Consideration should be given to the recent downturn in financial markets around the world. Given the interdependence of most of the world's economies, the United States could suffer serious financial troubles due to the financial crises taking place in Asia, Russia, and other areas. In this environment, the auditor should consider whether declines in fair value of securities will recover quickly or whether such declines are other—than temporary, as discussed in paragraph 16 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text*, vol. 1, sec. I08). The documentation of the evaluation of the other-than-temporary declines in fair value should be formal and well documented.

.03 Because audit risk can vary significantly depending on the types of investments that an insurance enterprise purchases, auditors should develop a thorough understanding of the insurer's investment strategy and the controls for monitoring compliance with its investment guidelines. In addition, audit procedures should focus on the following:

- The kinds of investments in an insurance company's portfolio
- The insurance enterprise's risk-management procedures
- The effectiveness of its asset-liability-matching strategies
- The concentration of investments (for example, collateralized mortgage obligations, bonds within a particular industry, common stock, or mortgage loans)
- The control procedures to ensure that investments are recorded at their proper values
- Whether any investments violate any restrictions included in the insurance company's domiciliary insurance laws and regulations

.04 Auditors also should be alert to valuation issues related to classification and impairment of securities. Paragraph 16 of FASB Statement No. 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.

.05 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 Securities and Exchange (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, the SEC staff will challenge management's—

- Previous assertion regarding the classification of the sold securities.
- Assertions regarding the classification of other held-to-maturity securities.
- Future assertions regarding the classification of securities purchased subsequently for an extended period of time (two years).

See the section titled "Investments in Hedge Funds" in this Alert for a further discussion of investment risks.



**Executive Summary—Investments**

- The global economic crisis may affect the valuation of investment securities. Auditors should consider whether declines in the fair values of securities will recover quickly, or whether such declines are other-than-temporary.
- In addition to other steps, auditors should develop an understanding of the insurer's investment strategy, and the controls for monitoring compliance with its investment guidelines.
- 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, the SEC staff will challenge management's assertions.

**Mutual Insurance Company Restructuring***How and why are some mutual insurance companies restructuring?*

.06 Mutual insurance companies are seeking better access to raise capital to enhance their financial flexibility and to support long-term growth. Because of many economic and regulatory factors, as well as increased competition, there has been a recent trend for mutual insurance companies to form mutual holding companies or to demutualize.

.07 Almost all states have some form of demutualization statute. There are a range of demutualization statutes and regulations that exist for life and property and casualty insurers. Typically, these laws contemplate a direct and full reorganization of the mutual insurer to a stock form. Some statutes permit policyholders to be compensated for their membership value through shares. Under some statutes, subscription rights or policy credits, rather than stock or cash, are offered. Once the company has determined an aggregate amount of compensation, the converting insurer is required to make a fair and equitable distribution to eligible policyholders.

.08 An alternative to demutualization is for a mutual insurance company to form a mutual insurance holding company (MIHC). The mutual insurer is converted to stock form and becomes a stockholder-owned entity that operates as a subsidiary of the newly formed MIHC. All the initial stock of the reorganized company is issued to the MIHC, which remains controlled by the former mutual insurance company's board of directors. The new stock insurer can now generate capital through an initial public offering. However, most statutes specify that the MIHC must own greater than 50 percent of the voting shares to ensure that it maintains effective control of the insurer. The policyholders become members of the MIHC through the transfer of their mutual membership interests to the MIHC, retaining the same voting rights they had previously. Policyholders remain participating life insurance contract policyholders in the converted stock insurer, but unlike with a demutualization, there is no distribution of equity or subscription rights to policyholders. The formation of an MIHC is usually quicker than a demutualization and tends to be less expensive. Because of the growth of this type of transaction, a number of states have enacted or are currently contemplating enacting MIHC statutes. Auditors should be aware that accounting and reporting issues may arise when these types of transactions take place.

**Mergers and Acquisitions***What should auditors be aware of during merger and acquisition activity?*

.09 Merger activity continues for both the life and property and casualty insurance industries. An overcapitalized industry and pressures on profit margins are factors contributing to the continuing merger and acquisition activity. Some believe that the financial services industry may see a regulation overhaul. Integration of banks, insurance companies, and securities firms has continued this year, and this consolidation trend will likely continue.

## Auditing Concerns

.10 The auditing and accounting issues that arise out of business combinations are numerous and varied. Auditors should carefully consider the individual client's circumstances first to identify those issues and then to develop an appropriate audit strategy. Examples of some of the issues that should be considered by auditors include the following:

- Careful consideration should be given to management's accounting for the business combination to ensure that all relevant generally accepted accounting principles (GAAP) have been considered. For example, if the pooling-of-interests method has been used, have the specific criteria of Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, been met?<sup>1</sup> If not, has the purchase price been allocated to the assets and liabilities acquired with goodwill properly calculated in accordance with the purchase method of accounting? If specialists have been used in asset or liability valuation, auditors relying on such information should consider the guidance set forth under Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336). The SEC has viewed the issue of goodwill with some concern recently and, accordingly, audit risk in this area may be especially acute for public companies. The SEC is also concerned that the discount rates commonly used in determining the fair value of the intangible asset representing in-force life insurance contracts (referred to in Emerging Issues Task Force [EITF] Issue No. 92-9, *Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company*, as present value of future profits [PVP]) may be inappropriately high in light of prevailing market interest rates and other current economic circumstances. Use of an excessive discount rate would result in understatement of the PVP asset and overstatement of goodwill. Auditors should also be alert to consensus positions reached this year by the FASB's EITF relating to business combinations. See the "EITF Consensus Positions" section of the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for more information.
- With consolidation comes dramatic change in the structure of an entity. In an effort to create greater cost efficiencies in the consolidated entity, departments may be combined and duplicative functions eliminated. Auditors should consider the impact of such changes on their client's internal control when making the assessment of control risk. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).
- Business combinations often result in the gain of a client for one auditor and a loss of a client for another. Thus, in the current environment, auditors may be more likely to find themselves in the role of either a predecessor or successor auditor. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place.
- Mergers and acquisitions may be effected in part through the use of debt financing. Auditors should carefully evaluate the terms of the debt agreement to identify, among other things, whether there are any loan covenants and, if so, the terms. Auditors should evaluate compliance with restrictive covenants and the implications of any loan covenant violations.
- The acquisition of an entity by one party may mean that another party has disposed of a business segment. Accordingly, auditors of the selling party should consider whether management has fol-

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<sup>1</sup> Accountants, other than the continuing accountant, who have been requested to provide advice on the application of accounting principles to specified transactions, such as whether a proposed business combination is in compliance with the pooling requirements of Accounting Principles Board Opinion No. 16 and other related generally accepted accounting principles, should refer to the guidance set forth under Statement on Auditing Standards No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625).

lowed the accounting and disclosure requirements of APB Opinion 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* (FASB, *Current Text*, vol. 1, sec. I13). Audit risk may be significant for discontinued operations involving an extended phase-out period. Auditors should give careful consideration to management's estimates when the disposal date of the segment occurs after year end. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.

- Subsequent to the business combination, auditors should consider whether management has prepared the financial statements of the combined entity in accordance with appropriate accounting standards, including FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FASB, *Current Text*, vol. 1, sec. C51), and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements* (FASB, *Current Text*, vol. 1, sec. C51).
- A business combination involving a public business enterprise may result in an operating segment subject to the disclosure requirements of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*. In such circumstances, auditors should consider the guidance set forth under Auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.22–.35).
- In purchase business combinations involving acquisitions of property and casualty insurance companies, the 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 Staff Accounting Bulletin (SAB) No. 61, *Loan Losses*, for further discussion).

Auditors involved with business combinations may want to be familiar with the information presented in the "Reserve Guarantees" part of the "Reinsurance Arrangements" section of this Alert.

#### Executive Summary—Mergers and Acquisitions

- Auditors should consider the possible auditing and accounting issues that might arise as a result of a business combination, including the accounting methods used, effects on internal control, predecessor and successor communications, and discontinued operations.
- The SEC has viewed the issue of goodwill with some concern recently, and has also been concerned that the discount rates commonly used in determining the fair value of the intangible asset representing in-force life insurance contracts may be inappropriately high.
- The 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.

### Property and Casualty Insurers

#### *What are some matters affecting property and casualty insurers?*

.11 Pricing issues continue for property and casualty insurers. Several property and casualty companies have taken down reserves in response to earnings pressure. Combined ratios to date are higher than last year. The unusually calm weather seen last year, thanks to El Niño's influence, has not been the case this year, as the hurricane season has produced a flurry of stormy weather so far.

## ***Alternative Risk Vehicles***

.12 Property and casualty insurers are exploring the capital markets as a way to finance risks and provide liquidity needed to grow their businesses. Insurers are looking to the capital markets as an alternative to traditional reinsurance. Some of the products include catastrophe-linked structured notes and traded catastrophe options. Reinsurers also are looking at opportunities provided by the capital market and have begun to take on capital-market risks. Examples include protecting companies against financial risk, such as foreign exchange and commodity price changes. Auditors need to evaluate the transactions carefully to determine whether to account for the transaction under the insurance or reinsurance GAAP models, or as a financial instrument. Some of these transactions may need to be accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50), when it becomes effective (see the “New Accounting Developments” section of this Alert for a discussion of FASB Statement No. 133). In addition, auditors should be aware of any potential audit risk associated with these transactions and consolidation issues.

## **Life and Health Insurers**

### *What are some matters affecting life and health insurers?*

.13 It appears that the life insurance industry has turned itself around by operating more efficiently and experiencing a stronger credit quality in insurers’ asset portfolios than in past years. The life insurance industry is making a strong attempt to battle a tarnished reputation caused by market conduct litigation cases. Many companies are responding to the market conduct concerns by joining the Insurance Marketplace Standards Association in hopes that their participation will provide a vehicle to detect the early emergence of market conduct problems.

## ***Nontraditional Life and Annuity Long-Duration Contracts***

.14 Life insurers have been selling fixed and variable annuities for many years. A traditional fixed, deferred annuity provides for a fixed rate of interest over some specified period, with the insurance enterprise bearing the investment risk associated with the cash received and invested in the insurance enterprise’s general account assets. A traditional variable annuity provides for the passage of all investment risks to the policyholder, with no guarantees of return of principal, minimum interest rates, or minimum death benefits. In the past several years, annuity products with nontraditional terms have been and continue to be developed. These products may have both fixed and variable features, or other, nontraditional features, such as:

- Variable annuity contracts with guaranteed return of principal or guaranteed return of principal plus minimum stated interest rate
- Fixed annuity contracts with guaranteed minimum interest rate plus a contingent return based on some internal or external index, most often the Standard & Poor’s 500 Stock Index (these are known as equity-indexed annuities)
- Contracts that provide for return of principal and interest if held until maturity, or a specified “market adjusted value” if surrendered at an earlier date (known as a market-value-adjusted annuity)
- Fixed annuities that provide a higher “teaser” rate in the first year of the contract, or a bonus interest rate if the contract is held for a specified period of time
- Variable annuity contracts that offer a minimum-death-benefit-guarantee option that varies depending on the performance of the related separate account investments

The features of these nontraditional contracts are numerous and complex; they may be offered in different combinations, so there are numerous variations of the same basic products being sold in the marketplace. In addition, such products may be sold as general account or separate account products. Auditors should be alert to the existence of these new products. The AICPA Accounting Standards Executive Committee (AcSEC) is currently studying the accounting and reporting issues associated with these new products.

## Regulatory Developments

*What new regulatory developments have occurred in the insurance industry?*

.15 The regulatory developments contained in this section include matters that affect audits of financial statements prepared in conformity with statutory accounting practices (SAP). 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 SAP-basis financial statements be provided as a supplement to the annual statement.

### Codification of Statutory Accounting Principles

.16 Insurance enterprises currently prepare SAP-basis financial statements in accordance with the accounting practices and principles prescribed or permitted by the insurance department of their state of domicile. These practices are considered to be an other comprehensive basis of accounting (OCBOA) under SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623).

.17 The NAIC has completed its project of codifying statutory accounting practices (the codification) for certain insurance enterprises. The codification project was originally designed to streamline accounting guidelines for regulators and insurers in one comprehensive source because current prescribed or permitted statutory accounting practices vary widely—not only from state to state, but also between insurance enterprises within a state. Furthermore, it will provide uniform statutory guidance that will facilitate analysis of annual statements filed by insurers.

.18 The effective date for codification is January 1, 2001. States may adopt the codification before January 1, 2001. The codification project title will be *Accounting Practices and Procedures Manual as of 19XX*. The year will be defined by the publication date, which is scheduled for 1999. In addition, the NAIC Ad Hoc Task Force on Codification Implementation recommended that the Financial Regulation Standards and Accreditation Subcommittee develop an approach that will make codification effective as an accreditation standard beginning January 1, 2002. The recommendation of the NAIC Ad Hoc Task Force on Codification Implementation has been adopted by the NAIC's Executive Committee.

.19 The AICPA currently is reviewing its guidance on reporting on SAP and will modify existing guidance as deemed necessary. Because the codification is not effective for 1998 statutory financial statements, auditors will continue to report on statutory financial statements prepared in conformity with the accounting practices prescribed or permitted by the insurance department of the state of domicile.

### Changes to Letter of Qualifications

.20 On November 3, 1995, the AICPA issued Statement of Position (SOP) 95-4, *Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule*, to provide guidance to auditors on the form and content of communications with state insurance regulators. Such communications are required by the NAIC's *Annual Statement Instructions Requiring Annual Audited Financial Statements*, which incorporates the January 1991 *Model Audit Rule (Regulation) Requiring Annual Audited Financial Statements*. The guidance in the SOP was effective for audits of statutory financial statements for periods ending on or after December 15, 1995.

.21 One of the illustrative letters that appears in SOP 95-4 is the accountant's letter of qualifications. Changes to the accountant's letter of qualifications have been made to comply with SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Paragraph *c* of the illustrative accountant's letter of qualifications has been revised as follows. (Please note that deletions appear as struck-out text and additions appear as underlined text.)

*Illustrative Accountant's Letter of Qualifications*

c. We understand that the Company intends to file its audited statutory financial statements and our report thereon with the Insurance Department of [name of state of domicile] and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory financial condition of the Company.

While we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, the Company and the insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with generally accepted auditing standards is to form an opinion and issue a report on whether the statutory financial statements present fairly in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile]. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to design plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, ~~that errors and irregularities that have a material effect on the statutory financial statements will be detected~~ and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting ~~irregularities~~ misstatements resulting from fraud. Because of the characteristics of ~~irregularities~~ fraud, particularly those involving ~~forgery and collusion, a properly designed and executed~~ concealment and falsified documentation (including forgery), a properly planned and performed audit may not detect a material ~~irregularity~~ misstatement resulting from fraud. In addition, an audit does not address the possibility that material ~~errors or irregularities~~ misstatements caused by fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control ~~structure~~ that will, among other things, provide 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 conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile].

The Insurance Commissioner should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditor's report.

**Executive Summary—Regulatory Developments**

- The NAIC has completed its project of codifying statutory accounting practices (SAP) for certain insurance enterprises. The effective date for codification is January 1, 2001. The AICPA is reviewing its guidance on reporting on SAP and will modify existing guidance as deemed necessary.
- Changes to the accountant's letter of qualifications in SOP 95-4 have been made to comply with SAS No. 82.

## Audit Issues

### Reinsurance Arrangements

#### *What should an auditor know about reinsurance arrangements?*

.22 Reinsurance is an important part of many insurance companies' business, and accordingly it is important for auditors to obtain an understanding of the reinsurance programs of the insurance companies they audit. The lack of an adequate reinsurance program may expose an insurance enterprise to risks that can jeopardize its financial stability, particularly if its risks are concentrated by type or geographic area. In contrast, excessive reinsurance coverage can significantly reduce the margins available to cover fixed expenses.

.23 A class of reinsurance agreements has been evolving in the insurance industry. Such contracts have the characteristics of derivative financial instruments and raise significant accounting issues, including whether—

- The insurance risk-transfer criteria of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FASB, *Current Text*, vol. 2, sec. In6), have been met.
- How to apply deposit accounting to such contracts that do not meet the insurance risk-transfer criteria of FASB Statement No. 113. (AcSEC will release its final SOP by the end of 1998, effective for years beginning after June 15, 1999.)
- In substance, the contract is a derivative financial instrument and, if so, what accounting is appropriate. Each contract should be evaluated based on the facts and circumstances. (FASB Statement No. 133 may be deemed to be applicable, which is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. See the "New Accounting Developments" section of this Alert for a discussion of FASB Statement No. 133.)

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 kinds of reinsurance arrangements may also indicate increased audit risk.

### *Risk-Transfer Issues*

.24 Paragraph 9 of FASB Statement No. 113 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.

Contracts that do not meet the conditions for reinsurance accounting should be accounted for as deposits. Some contracts may be difficult to evaluate, such as nonassumption reinsurance. Auditors should carefully evaluate all significant contracts.

.25 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 influence the assessment of risk transfer. Auditors should consider the guidance in EITF Issue Nos. 93-6, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Ceding and Assuming Enterprises*, and 93-14, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*.

### ***Reserve Guarantees***

.26 The FASB made two staff announcements at EITF meetings, one in November 1996 and one in November 1997, regarding the accounting by the purchaser for a seller's guarantee of the adequacy of liabilities for losses and loss-adjustment expenses of an insurance enterprise acquired in a purchase business combination. The announcements can be found in *EITF Abstracts*, Topic D-54, and provide guidance about what accounting guidance should be applied to certain transactions where loss and loss-adjustment expenses are guaranteed in a business combination accounted for as a purchase.

### ***Reinsurance Recoverables***

.27 An important audit procedure in the reinsurance area is the evaluation of credit 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. In addition, the AICPA Industry Guide *Audits of Stock Life Insurance Companies*<sup>2</sup> includes as an appendix the SOP, *Auditing Life Reinsurance*, which provides guidance on auditing reinsurance for life and health insurance enterprises.

### ***Disclosures About Reinsurance***

.28 Auditors should 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, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. 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.

### ***Reinsurance Arrangements and Statutory Capital and Surplus***

.29 Paragraph 60(h) of FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (FASB, *Current Text*, vol. 2, sec. In6), requires that financial statements contain disclosures regarding the amount of statutory capital and surplus of insurance enterprises calculated pursuant to state-mandated SAP. Auditors of insurance enterprises should carefully review reinsurance agreements and consider corresponding directly with state insurance departments to obtain sufficient evidence that material amounts of reserve credits used to reduce statutory reserves and increase the insurance enterprise's statutory capital and surplus have been properly computed in accordance with state laws. Most state insurance laws prohibit insurance enterprises from recognizing reserve credits pursuant to reinsurance agreements that do not transfer a sufficient amount of risk to the reinsurer. If material amounts of reserve credits associated with reinsurance arrangements do not qualify under state law, statutory capital and surplus may be materially misstated. Further, failure to meet the state's minimum capital and surplus requirements can lead to state-imposed restrictions on the enterprise's ability to sell insurance products in the state and its ability to distribute dividends and may call into question an enterprise's ability to operate as a going concern. In these situations, auditors should refer to SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341).

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<sup>2</sup> On September 4, 1998, the AICPA released for public comment proposed Audit and Accounting Guide *Life and Health Insurance Entities* that will supersede the current guide upon final issuance.



### Executive Summary—Reinsurance Arrangements

- An evolving class of reinsurance agreements that have the characteristics of derivatives has been evolving in the insurance industry. These derivative-like agreements raise significant issues, including whether FASB Statement No. 113 risk-transfer criteria have been met, and what accounting is appropriate. The existence of these agreements may increase audit risk.
- Certain reinsurance contracts, such as nonassumption reinsurance, and multiple-year, retrospectively rated reinsurance, may be difficult to evaluate in determining whether FASB Statement No. 113 risk transfer conditions are met, in order to apply reinsurance accounting. Auditors should carefully evaluate all significant contracts.
- EITF Topic D-54 provides recent guidance about reserve guarantees.
- The SEC staff expects registrants with material reinsurance recoverables to disclose information about the composition and quality of the asset balances.
- Auditors should consider corresponding 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.

## Liabilities for Unpaid Claims

*Do conditions exist that make liabilities for unpaid claims a high-risk audit area?*

.30 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.

.31 A number of conditions may be particularly indicative of a higher risk audit. They include the circumstances described in the following sections.

### *Exposure to Environmental and Asbestos-Related Claims*

.32 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. There is still significant uncertainty surrounding defendant activity, unresolved coverage issues, and policy and claim data availability issues for many insurers.

.33 FASB Statement No. 113 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* (FASB, *Current Text*, vol. 1, sec. 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, the enterprise must either (1) disclose the estimated additional loss or range of loss or (2) state that the loss 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 about the likelihood of realization of such recoveries. Auditors of insurance enterprises that face environmental and asbestos claims should carefully evaluate whether the accounting and disclosure requirements of SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, FASB Statement No. 5, and SAB No. 92 have been met. AcSEC is current-

ly working on a project to develop a proposed SOP, *Accounting for Mass Tort Exposures of Insurance Enterprise Including Environmental and Asbestos Claims*, and anticipates releasing an exposure draft in the second quarter of 1999.

### ***Estimating Environmental Claim Losses***

.34 As indicated in SAB No. 92, an insurance enterprise that is estimating reserves for environmental contamination claims should consider available evidence, including a particular policyholder's prior experience in the 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 more information to support a reasonable estimate of the amount or range of loss. When evaluating an insurance enterprise's reserves for environmental contamination claims, the auditor should consider the evidence currently provided by these expanded environmental databases.

.35 Furthermore, the auditors of publicly held insurance companies should consider whether the disclosures are in accordance with the requirements of SAB No. 87, *Views on Contingency Disclosures on Property-Casualty Insurance Reserves for Unpaid Claim Costs*.

### ***Long-Term Exposures***

.36 Long-term exposures (commonly referred to as mass tort exposures) involve bodily injury or property damage that arises from and is 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. The extent to which claims will be made by tobacco companies on their insurance carriers remains unclear. Auditors should consider these potential exposures when evaluating a company's loss reserves and adequacy of related disclosures.

### ***Changes in Product Mix to More Long-Tail Lines of Business***

.37 This factor would usually indicate more uncertainty in determining the ultimate exposure to claims.

### ***Intense Price Competition and Unexplained Premium Growth***

.38 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.

### ***Participation in Involuntary Pools***

.39 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.

.40 SAS No. 57, *Auditing Accounting Estimates*, 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 GAAS. 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.

**Executive Summary—Liabilities for Unpaid Claims**

- Auditors of insurance enterprises that face environmental and asbestos claims should evaluate whether the accounting and disclosure requirements of SOP 94-5, FASB Statement No. 5, and SAB No. 92 have been met.
- When evaluating reserves and disclosures related to environmental contamination claims, the auditor should consider the evidence provided by environmental databases, and the requirements of SAB No. 87.
- Auditors may want to consider potential exposure to tobacco-related illnesses and injuries related to extensive computer use when evaluating a company's loss reserves and the adequacy of related disclosures.
- Auditors should be alert to unsound pricing, crediting, or dividend policies, evidenced by unexplained premium growth.
- Auditors should be familiar with the guidance contained in SAS No. 57 and SOP 92-4, when auditing loss reserves.

**Surplus Enhancement**

*What are some matters an auditor should be on the lookout for concerning surplus enhancement?*

.41 In all audits of GAAP-basis and SAP-basis financial statements, consideration should be given to the effects of unusual transactions as well as audit differences on solvency and the adequacy of the company's SAP-basis capital and surplus. Auditors should evaluate transactions that materially affect SAP-basis income or surplus, or transactions for which the proposed effects on SAP-basis financial statements would be substantially different from the effects on GAAP-basis financial statements. That evaluation is especially important when an insurer's surplus is at or near minimum levels or when an insurer's risk-based capital ratio is at or near a regulatory action or control level.

.42 In addition, auditors should be alert for significant and unusual transactions or events at or near year end that may require significant judgment as to the proper accounting treatment, including:

- Financially oriented reinsurance transactions.
- Parking of securities.
- Loaning or borrowing securities.
- Intercompany transactions.
- Transactions involving special-purpose entities.
- Asset swaps.
- Asset reclassifications.
- Other types of potential "window dressing" transactions.

**Investments in Hedge Funds**

*Are there special concerns this year related to investments in hedge funds?*

.43 A hedge fund is a private-investment limited partnership that invests in a variety of securities. The hedge fund often uses money from investors to speculate on the difference in interest rates among securities and frequently trades in initial public offerings. Hedge funds use computer modeling and derivatives (which are often complex financial instruments whose value is derived from an underlying security, commodity, or asset) in hopes of producing a profit.

.44 There are two types of partners in a hedge fund, a general partner and limited partners. The general partner is the individual or entity who started the hedge fund. The general partner also handles all the trading activity and day-to-day operations of running a hedge fund. The limited partners supply most of the capital but do not participate in trading or day-to-day activities of running the hedge fund.

.45 Hedge funds typically engage in complicated trading strategies. Such strategies, designed to “hedge” investors from changes in currency and interest rates, require traders to predict the direction of those changes. Recently, a severe global economic and financial crisis has occurred, rendering the trading strategies of some hedge funds inadequate and causing serious losses. As investments broke down, hedge fund operators struggled to meet the demand for investor redemptions and margin calls from lenders who had financed the fund’s investments. In one well-publicized case, the Federal Reserve Bank organized a \$3.6 billion private bailout of Long-Term Capital Management Fund, L.P., a huge hedge fund with an estimated \$1.25 trillion exposure to international markets. The Federal Reserve Bank feared that the fund’s imminent collapse would further damage world markets.

.46 Currently, hedge funds are not subject to the same kind of strict disclosure requirements and oversight rules as mutual funds and are not currently required to disclose investors’ names or investment strategies. Banks, brokerage firms, and other financial institutions lending to a fund that collapses could face substantial losses, and unwinding of the fund’s positions could spur panic selling and losses for other investors.

.47 Auditors should be aware if their clients invest in hedge funds and should assess the risk related to those investments in light of the current difficulties some hedge funds are experiencing. SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on auditing investments. Auditors should also consider whether disclosure in the financial statements is necessary.

## Investments in Derivatives

*When an insurance company invests in derivatives, what should an auditor be concerned with?*

.48 For many companies, proper asset and liability management requires the use of derivative products. Insurance companies enter into derivative contracts for a variety of reasons, including investing, trading, and hedging. In recent years, the use of innovative financial instruments that are often complex and involve a substantial exposure to loss in the form of credit, market, pricing, and liquidity risk has become more frequent. Users and issuers of derivatives need the expertise to understand and manage the related risks. The use of derivatives creates unique audit concerns and may increase audit risk. For companies that use derivatives, an auditor’s assessment of audit risk requires an evaluation of the client’s systems and risk-management strategies.

.49 It is essential that auditors understand both the economics of derivatives used by their clients and the nature and business purpose of their clients’ derivative activities. In addition, auditors should carefully evaluate their clients’ accounting for such instruments.

.50 The determination of the fair value of derivative financial instruments may be a highly complicated matter. Varying methodologies can produce valuations that are materially different. Accordingly, along with understanding the products, the auditor should identify how the products are valued by the company and how those market valuations are independently verified.

.51 The fair value of certain securities and derivatives, such as exchange-traded options, generally is available from independent pricing sources (for example, financial publications and broker-dealers not affiliated with the entity). Determining fair value can be particularly difficult, however, if a transaction has been customized to meet individual user needs. Determining the value of customized interest rate swaps,

for example, requires various quantitative assumptions and modeling. Determining values for financial instruments that contain embedded derivatives requires complicated analysis using statistical modeling with numerous subjective inputs. Calculations of fair value for derivatives are complicated by the subjective value adjustments that are dependent on the specifics of the transaction, such as association of credit risk with the specified counter-party. Complex valuation models also involve risk of errors in data entry or assumptions, or the adequacy of the model.

.52 In auditing the values of derivatives, it is important to remember that in many cases quotations solely from a broker that is a counterparty to the transaction will not provide sufficient audit evidence to support the underlying value. Auditors should consider consulting with a valuation expert to test client valuations or to perform sensitivity analyses on the resulting values. Auditors should evaluate the work of any specialist used as required by SAS No. 73.

.53 In June 1998, the FASB issued Statement No. 133. See the “New Accounting Developments” section of this Alert for a description of the requirements of FASB Statement No. 133.

## International Matters

### *Will international accounting standards for insurance companies be developed?*

.54 The insurance industry, like many other industries, has entered the international arena. Certain differences exist between the U.S. insurance accounting model and other countries’ accounting models. Difficulties may arise when the U.S. accounting model is applied to non-U.S. insurance products, such as unit-linked products or non-U.S. participating contracts. The International Accounting Standards Committee (IASC) has set up a working group of practitioners and industry representatives from various countries to develop international accounting standards for insurance transactions. The IASC expects to expose an issues paper in early 1999 identifying all the insurance accounting issues for all countries.

## The Third Millennium Bug

### *What is the Year 2000 Issue and how will it affect insurance companies?*

.55 The inability of most computer programs to distinguish the year 1900 AD from the year 2000 AD poses substantial risks to all insurance enterprises. A significant number of computer operating systems and programs currently in use have six-digit date fields (YY/MM/DD), which represent, for example, December 31, 1999, by 99/12/31. The six-digit field, with only two digits for the year, is the basis for all date-related calculations within most computer systems today, particularly mainframes. The fundamental problem posed for these systems by the arrival of the year 2000 is that they have no way of expressing a date past year end 1999; 00/01/01 will be interpreted by them as January 1, 1900.

.56 The year 2000 problem is pervasive and complex. Virtually every organization will have its computing operations affected in some way by the rollover of the two-digit year value to 00. Insurance enterprises, service providers, and vendors need to address the risks associated with the coming millennium. Assuring that computer systems and applications are year 2000-compliant presents a complex managerial and technological challenge for all enterprises, both public and private. Achieving year 2000 compliance in mission-critical systems is essential not only for maintaining the quality and continuity of services, but also for assuring the very survival of the entity itself.

.57 The year 2000 is not only an information systems issue, but also an enterprise wide challenge that must be addressed at the very highest level of an insurance enterprise. Senior management and the board of directors should actively manage efforts to plan, allocate resources, and monitor progress to correct year 2000 problems.

## Auditing Issues

.58 First, it must be understood that it is the responsibility of an enterprise's management—not of the auditor—to assess and remedy the effects of the year 2000 on an entity's systems. Under GAAS, 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the year 2000 or by some other cause.

.59 Many auditing and accounting issues exist related to the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. These issues are fully discussed in the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. Auditors should be aware of these auditing and accounting issues and should understand the various auditing and accounting guidance that has been issued on the Year 2000 Issue. The general *Audit Risk Alert—1998/99* [AAM section 8010] can be obtained by calling the AICPA Order Department at (888) 777-7077.

## Permitted Statutory Accounting Practices

*If an insurance company uses "permitted accounting practices,"  
what guidance should an auditor follow?*

.60 Prescribed SAP are dispersed among the following:

- The insurance laws, regulations, and administrative rulings of each state
- The NAIC *Accounting Practices and Procedures* manuals
- The NAIC *Annual Statement Instructions*
- The NAIC *Financial Condition Examiners Handbook*
- The NAIC *Purposes and Procedures of the Securities Valuation Office* manual
- NAIC committee, task force, and working group minutes

.61 If an insurance company adopts an accounting practice (including an actuarial practice with accounting implications) that is not specifically prescribed in one of the aforementioned sources, that practice often is referred to as a permitted accounting practice. In that situation, the insurer should have received permission to use that practice from its domiciliary insurance department. Nevertheless, many insurers have considered certain accounting practices to be permitted even though they had not received specific written permission from their domiciliary insurance departments. Companies considered those practices permitted under a variety of circumstances, including the following:

- The practice had not been challenged during a regulatory examination.
- The practice was being used by other insurers.
- The company had notified the insurance department of the accounting practice but had not received a response.

.62 SOP 94-1, *Inquiries of State Insurance Regulators*, requires that, if a permitted accounting practice is material to an insurance enterprise's financial statements, the auditor obtain sufficient competent evidential matter to corroborate management's assertion that the accounting treatment is permitted. In many situations, that requirement will cause the auditor to obtain written confirmation, on an annual basis, from the domiciliary state insurance department that the accounting practice continues to be permissible.

.63 If the financial effect of such permitted practices is material, either individually or in the aggregate, to a company's SAP-basis surplus, sufficient competent evidential matter should be received before the issuance of an auditor's report on either the company's GAAP-basis or SAP-basis financial statements. When an auditor is unable to obtain such competent evidential matter for material permitted accounting practices, auditors should consider a qualification or disclaimer in their auditors' opinion on the GAAP-basis and the SAP-basis financial statements due to a scope limitation in accordance with SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508).

## New Auditing and Attestation Developments

### *What new auditing and attestation standards have been issued?*

.64 Presented below are descriptions of recently issued auditing and attestation pronouncements that may be applicable to insurance enterprises. For a complete list and description of all new auditing and attestation developments, including Audit Issues Task Force (AITF) Interpretations and AITF Advisories, auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. Call the AICPA Order Department at (888) 777-7077 to order.

### New Auditing Standards

#### **SAS No. 86, Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties**

.65 The Auditing Standards Board (ASB) issued SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), in March 1998 to reflect the issuance of Statement on Standards for Auditing Engagements (SSAE) No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners that have examined or reviewed management's discussion and analysis (MD&A) in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special type of agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

#### **SAS No. 87, Restricting the Use of an Auditor's Report**

.66 The ASB issued SAS No. 87, *Restricting the Use of an Auditor's Report*, in September 1998, and it is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The SAS states that an auditor should restrict the use of a report when—

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or OCBOA.
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used

in restricted-use reports, and requires an auditor to restrict a combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

### **SAS No. 21, Segment Information—Rescinded**

.67 SAS No. 21, *Segment Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 435), contained guidance for auditing disclosures made in accordance with the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 was superseded upon the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, which is effective for fiscal years beginning after December 15, 1997. Accordingly, the ASB has rescinded SAS No. 21 effective for audits of financial statements to which FASB Statement No. 131 has been applied. In its place, auditing Interpretation No. 4, “Applying Auditing Procedures to Segment Disclosures in Financial Statements,” of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.22–35), has been issued. See the “New Auditing Interpretations and AITF Advisory” section of the general *Audit Risk Alert—1998/99* [AAM section 8010] for a more detailed discussion of the new Interpretation.

### **New Attestation Standard**

.68 Issued by the ASB in March 1998, SSAE No. 8, *Management’s Discussion and Analysis*, provides guidance to a practitioner concerning the performance of a review or examination of MD&A prepared pursuant to the SEC’s rules and regulations. The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8—

1. Sets conditions for engagement performance for both examinations and reviews of MD&A.
2. Provides extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A.
3. Provides a comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8.

SSAE No. 8 became effective upon issuance.

.69 In September 1998, the ASB voted to issue the exposure draft *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity’s Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation* as a final standard. See the “Exposure Draft Issued by the Auditing Standards Board” section of the general *Audit Risk Alert—1998/99* [AAM section 8010] for further information.

### **New Statement of Position**

.70 In April 1998, SOP 98-6, *Reporting on Management’s Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*, was issued under the authority of the ASB. This SOP pertains to the sales and marketing policies and procedures of life insurance entities. The SOP provides guidance to practitioners in conducting and reporting on an independent examination of management’s assertion about those policies and procedures performed under SSAE No. 1, *Attestation Standards* (AICPA, *Professional Standards*, vol. 1, AT sec. 100), to assist an entity in meeting the requirements of the Insurance Marketplace Standards Association (IMSA) program. IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its Assessment Handbook and requirements.



.71 This SOP amends chapter 9, "Auditors 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*.

### ***Life and Health Insurance Entities Audit and Accounting Guide***

.72 On September 4, 1998, the AICPA released for public comment a proposed Audit and Accounting Guide, *Life and Health Insurance Entities*. The proposed Guide would supersede the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*. Comments are due December 4, 1998.

.73 The proposed Guide discusses those aspects of accounting and auditing unique to life and health insurance entities; it was developed to assist life and health insurance entities in preparing financial statements in conformity with GAAP and to assist independent auditors in auditing and reporting on those financial statements. In addition, the proposed Guide contains significant discussions of SAP, including laws, regulations, and administrative rulings adopted by the various states that govern the operations and reporting requirements of life insurance entities. The proposed Guide does not reflect SAP under the NAIC codification and will be updated to reflect those standards during the exposure period.

.74 The proposed Guide also incorporates accounting and financial reporting requirements issued by the FASB and the AcSEC since the issuance of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*. Also incorporated in this proposed Guide are new auditing standards issued by the ASB since the issuance of original audit and accounting guide.

.75 The proposed Audit and Accounting Guide *Life and Health Insurance Entities* is not intended to establish any new accounting standards or interpret any existing accounting standards, except for the inclusion of an SEC staff announcement of the accounting for the interaction of (a) unrealized gains and losses reported for marketable securities classified as available for sale under FASB Statement No. 115 and (b) minority interest, liabilities for Guaranteed Interest Contracts (GICs), and policyholders' share of investment results with assets, in particular, deferred policy acquisition costs (DAC) and present value of future profits of acquired life insurance companies made at the July 12, 1994, EITF meeting.

.76 One free copy of the exposure draft can be obtained from the AICPA Order Department by calling (888) 777-7077 and asking for Product No. 800122. The exposure draft is also available on the AICPA Web site ([www.aicpa.org](http://www.aicpa.org)). Written comments should reference File 3162.LG and be emailed to [elehnert@aicpa.org](mailto:elehnert@aicpa.org) or sent to Elaine M. Lehnert, Technical Manager, Accounting Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775.

#### **Executive Summary—New Auditing and Attestation Developments**

- See the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a thorough listing of new auditing and attestation developments.
- SAS No. 86, Amendment to SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties*
- SAS No. 87, *Restricting the Use of an Auditor's Report*
- SAS No. 21, *Segment Information—Rescinded*
- SSAE No. 8, *Management's Discussion and Analysis*
- SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*
- Proposed Audit and Accounting Guide *Life and Health Insurance Entities*

## New Accounting Developments

### *What new accounting developments have occurred?*

.77 Presented below are descriptions of some recent accounting developments that may affect the financial statements of insurance enterprises. Auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a complete listing and description of recent GAAP developments, including FASB EITF consensus positions and AICPA SOPs. Call the AICPA Order Department at (888) 777-7077 to order.

### New FASB Statements

#### **FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106**

.78 In February 1998, the FASB issued Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (FASB, *Current Text*, vol. 1, secs. P16 and P40). FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statements No. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16), No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, sec. P16), and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40), were issued. Statement No. 132 suggests combined formats for presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

.79 Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

#### **FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities**

.80 In June 1998, the FASB issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (b) a hedge of the exposure to variable cash flows of a forecasted transaction; or (c) a hedge of the foreign-currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.81 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.82 For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair-value hedge), the gain or loss is recognized in earnings

in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

.83 For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash-flow hedge), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

.84 For a derivative designated as hedging the foreign-currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair-value hedge described above applies to a derivative designated as a hedge of the foreign-currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash-flow hedge described earlier applies to a derivative designated as a hedge of the foreign-currency exposure of a foreign-currency-denominated forecasted transaction.

.85 For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.86 Under FASB Statement No. 133, an entity that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

.87 FASB Statement No. 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction, except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign-currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

.88 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign-currency-forecasted transaction with a derivative. It supersedes FASB Statements No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107 to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. Statement No. 133 also nullifies or modifies the consensuses reached in a number of issues addressed by the EITF.

.89 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

### ***Accounting for Mortgage-Backed Securities***

.90 In October 1998, the FASB issued Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB

*Statement No. 65.* FASB Statement No. 65, as amended by FASB Statement Nos. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Current Text*, vol. 2, sec. No4), requires that, after the securitization of a mortgage loan held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed security as a trading security. This Statement further amends FASB Statement No. 65 to require that after the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed securities or other retained interests based on its ability and intent to sell or hold those investments. This Statement conforms the subsequent accounting for securities retained after the securitization of mortgage loans by a mortgage-banking enterprise with the subsequent accounting for securities retained after the securitization of other types of assets by a nonmortgage-banking enterprise.

.91 This Statement shall be effective for the first fiscal quarter beginning after December 15, 1998. Early application is encouraged and is permitted as of the issuance of this Statement. On the date this Statement is initially applied, an enterprise may reclassify mortgage-backed securities and other beneficial interests retained after the securitization of mortgage loans held for sale from the trading category, except for those with sales commitments in place.<sup>3</sup> Those securities and other interests shall be classified based on the entity's ability and intent, on the date this Statement is initially applied, to hold those investments. Transfers from the trading category that result from implementing this Statement shall be accounted for in accordance with paragraph 15(a) of FASB Statement No. 115.

## New Statements of Position

### **SOP 97-3, Accounting by Insurance and Other Enterprises for Insurance-Related Assessments**

.92 On December 10, 1997, the AICPA issued SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments* (formerly titled *Accounting by Insurance and Other Enterprises for Guaranty-Fund and Certain Other Insurance-Related Assessments*). This SOP provides guidance on accounting by insurance and other enterprises for insurance-related assessments. The SOP states that:

- An enterprise should recognize a liability for insurance-related assessments when all the following conditions are met:
  1. An assessment has been imposed or information available before issuance of the financial statements indicates it is probable that an assessment will be imposed.
  2. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.
  3. The amount of assessment can be reasonably estimated.

.93 **Retrospective-Premium-Based Guaranty Fund Assessments.** An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.

.94 **Prospective-Premium-Based Guaranty Fund Assessments.** The event that obligates the entity for the assessment liability generally is the writing of, or becoming obligated to write or renew, the premiums on which the expected future assessments are to be based. Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

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<sup>3</sup> Mortgage-backed securities and other beneficial interests may be reclassified from the trading category when initially applying this Statement without regard for the provisions in paragraph 15 of FASB Statement No. 115, which states that "given the nature of a trading security, transfers into or from the trading category . . . should be rare."

**.95 Prefunded-Premium-Based Guaranty Fund Assessments.** A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related premiums are written.

**.96 Other Premium-Based Assessments.** Other premium-based assessments would be accounted for in the same manner as prefunded-premium-based guaranty fund assessments.

**.97 Loss-Based Assessments.** An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability as the related loss is incurred.

**.98** This SOP is effective for financial statements for fiscal years beginning after December 15, 1998. Early adoption is encouraged. Previously issued annual financial statements should not be restated. Initial application of this SOP should be as of the beginning of an enterprise's fiscal year (that is, if the SOP is adopted before the effective date and during an interim period other than the first interim period, all prior interim periods should be restated). Enterprises should report the effect of initially adopting this SOP in a manner similar to a cumulative effect of a change in accounting principle (refer to paragraph 20 of APB Opinion 20, *Accounting Changes*).

### **SOP 98-7, Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk**

**.99** In October 1998, AcSEC issued SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts that Do Not Transfer Insurance Risk*. The SOP will address deposit accounting for certain insurance and reinsurance contracts and direct business by insurance enterprises and other enterprises. SOP 98-7 will provide guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. It applies to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long-duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to in the SOP as deposit accounting. SOP 98-7 does not address when deposit accounting should be applied.

**.100** The SOP specifies the following:

1. Insurance and reinsurance contracts for which the deposit method is appropriate should be classified as one of the following, which are those—
  - That transfer only significant timing risk.
  - That transfer only significant underwriting risk.
  - That transfer neither significant timing nor underwriting risk.
  - With indeterminate risk.
2. At inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting and should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract.

The SOP would adopt the interest method as described in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (FASB, *Current Text*, vol. 1, sec L10), for insurance and reinsurance contracts that transfer only significant timing risk and insurance and reinsurance contracts that transfer neither significant timing nor underwriting risk.

**.101** Insurance and reinsurance contracts that transfer only significant underwriting risk would be accounted for by measuring the deposit based on the unexpired portion of the coverage provided until losses

are incurred that will be reimbursed under the contract. Once a loss is incurred that will be reimbursed under the contract, the deposit would be measured by the present value of the expected future cash flows arising from the contract plus the remaining unexpired portion of the coverage provided. Changes in the recorded amount of the deposit, other than the expired portion of the coverage provided, would be included in the income statement of the insured as an offset to the loss that will be reimbursed under the contract.

.102 Insurance and reinsurance contracts with indeterminate risk would be accounted for in a manner similar to the open-year method described in SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance*.

.103 SOP 98-7 is effective for financial statements for fiscal years beginning after June 15, 1999, with earlier adoption encouraged. Restatement of previously issued annual financial statements is not permitted. Initial application of this SOP is as of the beginning of an entity's fiscal year (that is, if the SOP were adopted before the effective date and during an interim period, all prior interim periods are required to be restated). The effect of initially adopting this SOP should be reported as a cumulative effect of a change in accounting principle (in accordance with the provisions of APB Opinion 20).

#### Executive Summary—New Accounting Developments

- See the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a thorough listing of new accounting developments.
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statement Nos. 87, 88, and 106*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65*
- SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*
- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*

## References for Additional Guidance

*What are some organizations that can provide more information about the insurance industry?*

.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 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.

.107 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

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.108 This Audit Risk Alert replaces *Insurance Industry Developments—1997/98*.

\* \* \* \*

.109 Practitioners should also be aware of the economic, regulatory, and professional developments described in the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] and *Compilation and Review Alert—1998/99* [AAM section 8015], which may be obtained by calling the AICPA Order Department at (888) 777-7077.

.110 The *Insurance Industry Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may email these comments to [Rdurak@aicpa.org](mailto:Rdurak@aicpa.org), or write to:

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# Information Sources

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Organization	General Information	Fax Services	Internet	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	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
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	www.naic.org	
U.S. General Accounting Office	Superintendent of Documents U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	Information Line (202) 512-2250	www.gpo.gov	
U.S. Securities and Exchange Commission	Publications Unit 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046	Information Line (202) 942-8090, ext. 3 (202) 942-8092 (tty)	www.sec.gov	

[The next page is 8139.]



## AAM Section 8050

# *Depository Institutions and Lending Industry Developments—1998/99*

### In This Year's Alert . . .

- What fundamental changes are occurring in the industry?
- How has the depository institutions and lending industry been generally performing?
- What matters affecting credit risk should a CPA be aware of?
- What, briefly, are these global economic problems all about, and how do they affect financial institutions?
- What is the SEC saying about provisions for credit losses?
- What has resulted from the huge legislative battle over credit union membership?
- What efforts are under way to update the nation's laws and regulations governing her financial institutions?
- Is management of financial institution clients subject to unusual stresses these days?
- What is the Year 2000 Issue and how will it affect financial institutions?
- What are EMU and the Euro all about?
- What should a CPA know about banks getting involved in securities underwriting?
- Why are financial institutions offering brokerage accounts to customers, and what concerns exist?
- What are the issues connected to the ongoing movement of financial institutions into the insurance business?
- Why are institutions engaging in the business of leasing cars and equipment to customers, and what should a CPA be aware of in auditing such activities?
- Are dwindling deposit levels a concern?
- How does the current wave of refinancings affect financial institutions and audit risk?
- Are there concerns over the outsourcing of internal audit activities?
- What does one need to be concerned with regarding repurchase agreements?
- Given the upswing in loan participations, what should a CPA remember about such transactions?
- What precisely is money laundering all about, and what are a CPA's responsibilities?
- With what countries and entities are financial institutions prohibited from doing business?
- What significant regulatory developments have occurred?
- What new auditing and attestation standards have been issued?

- What new standards have been issued by the FASB?
- What are some organizations that can provide more information about the industry?

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## Purpose of This Alert

.01 CPAs, as trusted professionals, deliver value to their clients by communicating the events, issues, and risks occurring in an industry with clarity and objectivity. CPAs provide assurance to their clients by performing valuable audit services and rendering an audit opinion. In addition, CPAs provide a variety of assurance services that improves the quality of information, or its context, for decision makers.

.02 This Alert helps CPAs provide top-quality audit services to their clients in the depository institutions and lending industry and helps CPAs provide relevant information to those clients, thus adding value to the business decision-making process. The information in this Alert bolsters a CPA's audit planning efforts in considering industry matters, such as economic conditions, government regulations, competitive conditions, and other risks and issues affecting financial institutions. Moreover, this Alert helps CPAs analyze and interpret relevant information and converging information.

.03 CPAs who understand what is happening in the depository institutions and lending industry, and who can interpret and add value to that information, will be able to offer valuable service and advice to their clients. This Alert assists CPAs in making solid and rapid strides in gaining that industry information and understanding it.

.04 It is best to read this Alert in conjunction with the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. To order, call the AICPA Order Department at 1-888-777-7077.

## Industry and Economic Developments

### Fundamental Changes in the Financial Services World

*What fundamental changes are occurring in the industry?*

.05 The financial services industry is changing rapidly and fundamentally. Commercial banks, credit unions, investment banks, thrifts, mortgage servicers, brokerages, insurance companies, mutual funds, credit card issuers, and finance companies are involved in sweeping mergers and acquisitions across the country and worldwide. Institutions at all levels of the industry are merging. Significant consolidations have been occurring for years, but the rate of consolidations has now skyrocketed to unprecedented heights. In addition to the unparalleled consolidations taking place, the different sectors within the financial services industry are converging. The banking industry, brokerage industry, insurance industry, and other financial sectors are losing their distinctions from one another, leaving one industry—financial services. Indeed, the financial institution is being reinvented.

.06 The proposed merger of Citicorp and Travelers Group (Citigroup) has accelerated the already furious consolidation and convergence pace within the industry. This proposed financial behemoth will be the largest financial services company in the world, with \$700 billion in assets. The new Citigroup will represent a global financial service supermarket offering a full line of financial products through many diversified distribution channels to corporate and consumer customers worldwide. Another prominent proposed merger includes BankAmerica Corp. and NationsBank Corp., which formed BankAmerica, a \$570 billion-asset coast-to-coast banking kingdom. Banc One Corp. merged with First Chicago NBD Corp., creating a \$230 billion company.

Additionally, Washington Mutual, Inc. joined with H.F. Ahmanson & Co., forging the largest thrift in the country, with \$149 billion in assets. Three enormous deals—First Union Corp. and the Money Store, Conseco Inc. and Green Tree Financial Corp., and Household International Inc. and Beneficial Corp.—have radically reshaped the world of consumer finance. Other noteworthy combinations include—

- Fleet Financial Group and Quick & Reilly Group.
- U.S. Bancorp and Piper Jaffray Cos.
- Norwest Corp. and Wells Fargo & Co.
- National City Corp. and First of America Bank Corp.
- Star Banc Corp. and Firststar Corp.
- SunTrust Banks Inc. and Crestar Financial Corp.

.07 Many people in the industry predict a polarized financial services world will eventually exist, dominated by a handful of very large, super institutions coexisting with small community institutions and specialty niche players.

.08 Congress and regulators have not been able to keep up with the rapid consolidation and convergence of the financial services industry. The Citicorp/Travelers Group merger runs afoul of the current regulatory environment, by combining banking and insurance underwriting in one company. Under current law, Citigroup would have to divest its underwriting business in five years. However, Citigroup is betting that the current regulatory structure will change in its favor before then. Without a doubt, important questions about financial regulations have arisen in this current environment. Congress and the various regulatory authorities must rethink how financial institutions are regulated and allowed to operate. Many believe that financial modernization legislation (see “Modernizing the Country’s Financial Framework” section of this Alert) may be needed to address the fundamental transformation occurring in the industry.

.09 As a result of the frenzied pace of mergers and acquisitions, the financial services industry continues to shrink. However, this industry-wide consolidation and convergence has also contributed to a very significant increase in the number of new, smaller, community institutions, which are taking advantage of readily available capital. With the market for small business loans growing rapidly, community institutions are also targeting small business owners and customers who enjoy highly personalized service.

.10 The idea of global financial service supermarkets (integrating lending and deposit taking, insurance activities, investment banking, and brokerage activities under one roof) is back in fashion. This idea has been in and out of fashion before. In Europe and Canada, the convergence of different financial service sectors is commonplace. However, success stories are few. European financial conglomerates have not lived up to expectations, and in the United States one can find past examples of failed attempts to create financial supermarkets.

.11 The fundamental changes taking place in the industry are expected to continue for years to come. More mergers and acquisitions are likely to occur because of the number of potential targets and potential acquirers. A series of combinations among small and medium-sized institutions is possible because regional and superregional institutions may search for partners, to remain competitive. Combinations of financial institutions and brokerage firms are also expected to continue. Many believe that size and scale are essential to survival, and those who fail to act today will not be around tomorrow. Others see promising opportunities for small community organizations, catering to customers disenchanted with mega financial institutions. More combinations are likely to come, and many management teams are trying to figure out how to react.

### *The Reasons for and Benefits of Combining*

.12 When financial institutions combine, they hope to achieve the following results:

- Boost earnings and share price
- Boost revenue sources
- Diversify geographically
- Expand and diversify product lines
- Increase access to capital
- Reduce cost of capital
- Gain economies of scale; achieve efficiencies
- Broaden customer base or market share
- Beat the competition
- Cross-sell products
- Enhance investment specialist role
- Cut expenses and jobs
- Lower prices
- Create convenience for customers
- Participate in securities underwriting
- Increase productivity

These goals are certainly not new. Today, however, certain conditions exist that make the time ripe for institutions to combine and race to become full-service companies, grabbing as much market share and revenue as they can. Those conditions include the following:

- The traditional business of lending and taking deposits currently produces very thin profit margins due to intense competition and inexpensive distribution channels. This business exhibits slow growth and overcapacity. Growth must come from elsewhere.
- Mutual funds and similar enterprises are increasingly swallowing up investment dollars from potential customers. The money pouring into these funds is in large part due to the growing widespread use of personal retirement plans. Financial institutions want to provide their customers with mutual fund and brokerage services to gain a piece of those investment dollars.
- Rapid deregulation in the financial services industry is creating a conducive environment for the strong forces of consolidation and convergence.
- Significant write-downs among some consumer finance companies, caused by a wave of refinancings, have contributed to the mergers taking place among those companies.
- Certain segments of the population have amassed great wealth, owing in large part to the extended U.S. economic boom. Many of these people are sophisticated investors who demand new investment options. Financial institutions are gearing up and trying to meet those demands and gain a share of that wealth.
- Peer pressure influences management to pursue deals, lest their institutions fall behind.
- The well-documented globalization trend is convincing many that the future belongs to extremely large financial supermarkets.
- The mortgage servicing and securities sectors have very thin profit margins. As such, merging into bigger entities creates the large volume of transactions necessary to generate sufficient earnings.

A confluence of these conditions and the advantages of combining foster the sweeping changes taking place in the financial services industry.

.13 Institutions that combine believe bigger is better. They are convinced that their corporate and consumer customers desire one-stop shopping for all their financial needs. Ever-improving technology is an important factor in making that one-stop financial shopping possible. By gaining size, institutions will be able to offer their customers unprecedented access to capital and a wide array of financial products. One of the keys to success will be the combined institution's ability to cross-sell its new array of products to an enlarged customer base. For example, by combining with a finance company, an insurance entity hopes to sell its various insurance products to the finance company's large base of subprime loan customers. This cross-selling will be enhanced by the combined entity's ability to invest heavily in technology, enabling it to mine its customer databases and target its products effectively.

.14 Many would also argue that a big advantage to the intense industry consolidation and convergence is a healthier U.S. banking system. Larger institutions tend to be geographically diversified, which protects them from severe economic problems in any one region of the nation. In addition, these larger institutions can further diversify their risks by offering many different financial products.

### *Merged Institutions Face Many Challenges*

.15 Institutions engaged in consolidation and convergence face significant challenges. They include the following:

- The combining institutions will integrate their systems with much difficulty. The institutions normally maintain different computer systems and normally possess many independent internal applications. They will have to integrate such important operations as credit card systems, risk management, credit risk, and trading. The combining entities will pay substantial bills to integrate operations, and they will normally take years to complete the integration. Moreover, these entities have already committed their resources to year 2000 and Euro conversion projects (see these topics in following sections). If system integration is mishandled, combining institutions may not fully know their financial position and operating results.
- Customers may leave financial institutions that merge. These customers may not receive the same personal service that they received before the merger. For instance, they may be forced to call automated phone centers instead of real people or may be charged higher fees for services. Small business customers may be neglected by the larger, combined institution as well. Keeping these disenfranchised customers will be a serious issue for combining entities.
- The merged entities may not achieve the revenue growth they expected. They may not be able to easily cross-sell products and aggressively market a national brand name.
- Management of the combining institutions could be choosing the wrong vision of the future. After the combination, management will promote their house brands of financial products. In contrast, management of other financial services companies, such as discount brokerage firms, are promoting financial products from a variety of manufacturers that specialize in particular areas. Have the management teams of the merging entities miscalculated the trend of more and more customers performing their own research and using inexpensive companies to do their investing? Furthermore, has management miscalculated investors' willingness to explore the Internet and purchase financial products offered by a multiplicity of institutions?
- The combined entity may suffer internal control weaknesses. Through cost-cutting and layoffs, the institution may strip away important control-related positions and functions. At the same time, the entity will be integrating two different company cultures and making many personnel decisions. As a result, the entity could encounter control problems caused by disgruntled employees.

- Management of the newly merged entity may not realize the cost savings they expected. In fact, management may incur unexpected merger-related expenses. In addition, management's failure to cut costs and meet market expectations could cause the institution's stock price to tumble.
- Consumer groups and certain lawmakers are raising a chorus of protests over the consolidation of the industry. They believe that mergers reduce competition and hurt the average customer.

In brief, management of the newly merged entity must manage the institution well for the merger to succeed. They must adequately appreciate other important measurements such as profitability and productivity, in addition to asset size.

.16 Beyond the challenging issues confronting the merged institutions, the country may also be facing certain challenging concerns. The nation may find danger in very concentrated allocations of capital. When insurance and trading losses penetrate firewalls and cut into an institution's capital, will the nation be willing to spend significant tax dollars to bail out huge financial supermarkets and other large institutions? To be sure, the nation and the banking industry will be dealing with some weighty issues.

### *The Merger Mania Presents Challenges and Opportunities for Mid- and Small-Sized Institutions*

.17 Mid- and small-sized institutions will find difficulty competing with the larger, combined institutions. They will not possess the economies of scale that the merged entities possess and they generally will not enjoy the geographic and product diversity that the larger institutions covet. Moreover, mid- and small-sized entities' customers will be targeted by the immense marketing efforts of the newly combined institutions. High-priced and high-cost financial institutions are predicted to be driven out of the market by the tremendous consolidating forces in the industry. In fact, mid-sized institutions are predicted by some industry analysts to disappear altogether, leaving behind very large financial entities and small community institutions.

.18 Management of mid- and small-sized institutions will find opportunities arising from the consolidation and convergence occurring in the industry. Customers, in general, distrust large financial institutions and can become dissatisfied with the poor, impersonal service and higher fees they sometimes receive from newly combined organizations. Management of mid- and small-sized entities can gain customers and improve their businesses by providing good relationship-based service, convenience, and low fees. They must also invest in technology and broaden their product lines to prosper in the current environment. Owing to the smaller size of their businesses, management of mid- and small-sized institutions generally are better able to manage their operations and focus on their markets. By leveraging those advantages and seizing the above-mentioned opportunities, management of mid- and small-sized financial entities can lead their businesses to higher levels of growth, earnings, and profitability.

### *Auditing Issues*

.19 *Accounting for Mergers and Acquisitions.* A business combination, according to Accounting Principles Board (APB) Opinion 16, *Business Combinations* (FASB, *Current Text*, vol. 1, sec. B50), occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity that results carries on the activities of the previously separate independent enterprises. The auditing and accounting issues that arise out of corporate consolidations are numerous and varied. Auditors should evaluate the accounting for merger-related transactions. Significant financial statement misstatements can result if management of the combined institution improperly values assets or mishandles the complicated accounting for the merger. While examining the accounting for the combination, auditors should consider the consensus positions reached by the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) relating to business combinations, including the guidance contained in EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*. Subsequent to the business combination, auditors should consider whether management has prepared the financial statements of the combined entity in accordance with appropriate accounting stan-

dards, including FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FASB, *Current Text*, vol. 1, sec. C51), and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements* (FASB, *Current Text*, vol. 1, sec. C51).

**.20** Furthermore, auditors should assess whether pooling-of-interests accounting or purchase accounting is appropriate for the combination. The Securities and Exchange Commission (SEC) has expressed concern over the wide use of and possible misapplication of pooling-of-interests accounting. Auditors and management may need to consult with specialists to assess the appropriateness of pooling-of-interests accounting. Finally, auditors should read chapter 14 of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* for further guidance.

**.21 *Accounting for Restructuring Charges.*** Combining financial institutions often restructure their operations. They eliminate redundant functions and attempt to create an efficient and streamlined organization. Management and auditors should be aware of the requirements of EITF Issue Nos. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, and 95-3. When liabilities are accrued in accordance with the guidance in EITF Issue Nos. 94-3 and 95-3, certain disclosures are required. The thresholds for making the required disclosures are related to the materiality of the amounts accrued or the significance of the activities that will not be continued. Therefore, when the disclosure thresholds have been met, all the disclosures are required, not just those that are individually material.

**.22** Some of the disclosures are required until the plan of termination is completed or until all actions under a plan to exit an activity or involuntarily terminate employees of an acquired company have been fully executed. For instance, under EITF Issue No. 94-3, the amount of actual termination benefits paid and charged against the liability and the number of employees actually terminated as a result of the plan to terminate the employees must be disclosed. The amount of any adjustments to the liability also must be disclosed.

**.23** The SEC staff has observed an increasing frequency of subsequent reductions to restructuring liabilities, which suggests that management may be “providing a cushion” in establishing such reserves. When reviewing management’s accruals, auditors should be aware of the kinds of charges that are allowed to be accrued for pursuant to EITF Issue Nos. 94-3 and 95-3 (and other relevant accounting literature, as appropriate), and be mindful that management’s estimates are not overly conservative.

**.24** Additionally, the SEC staff has stated that liabilities accrued in accordance with EITF Issue Nos. 94-3 and 95-3 are valuation accounts that should be disclosed on Schedule VIII, Valuation and Qualifying Accounts, of SEC registrants’ annual reports filed on Form 10-K.

**.25 *Internal Control Weaknesses Resulting From Mergers.*** Subsequent to a merger, management typically reduces personnel and eliminates positions and functions in hopes of saving money and gaining efficiencies. Management’s actions may cause gaps in internal control. For instance, management may eliminate a supervisory position at a branch. That supervisor may have performed internal control activities that now will no longer exist. Management may shift personnel to different positions and alter the way things have always been done. By making these moves, they risk creating deficiencies in internal control and in business operations. Also, in dealing with the many internal control issues arising from a merger, management may forget about basic internal controls and assume that such controls are operating when in fact they may not be. Auditors should take these issues into account in their consideration of internal control and their assessment of control risk. These gaps and deficiencies in internal control may represent reportable conditions or weaknesses in internal control that should be communicated to management and the audit committee. Auditors should refer to the guidance set forth under Statement on Auditing Standards (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 Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

**.26 Effects of Adding and Expanding Product Lines, Services, and Businesses.** Financial institutions that add or expand products, services, and businesses generate risks to themselves and to auditors. Often, institutions that combine, and those that have not undergone a merger, add and expand products, services, and businesses. Combining institutions may join together different financial sector products and services (for example, insurance, checking accounts, loans, asset management, and brokerage services) under one roof. The CPA should consider the following factors when the institution, whether it is involved in a combination or not, is adding or expanding products, services, or businesses.

- Management may lack expertise in the new areas. For example, management may not possess the knowledge and skills needed to manage the business and risk of selling insurance. CPAs may want to assess management's level of expertise in the new areas of business and consider that assessment in the determination of their audit procedures.
- Management may not properly implement industry-specific accounting principles related to the new areas. Auditors should determine that proper accounting principles are being applied concerning the new areas of business, if such matters are material.
- The accounting, operations, and other systems related to the new areas may lack adequate testing and proper integration with core systems. Thus, these new systems may have inadequate internal control, which may result in unreliable accounting data. Auditors should consider this when planning and performing the audit. In addition, auditors should be familiar with the requirements of SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). According to SAS No. 60, auditors may become aware of matters relating to internal control that, in their judgment, should be communicated to the audit committee. Such matters represent significant deficiencies in the design or operation of internal control, which could adversely affect the institution's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
- The institution may fail to comply with regulations attendant to the new area of business. The institution's failure to comply may result from an unfamiliarity with the regulations and a lack of expertise in the new area. Auditors may want to inquire about the regulations that exist in new business areas (to the extent necessary to perform a proper audit). SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), describes an auditor's responsibilities regarding violations of laws or governmental regulations.

In short, management should enter only new areas of business that are appropriate to the nature of their financial institution. They should establish a risk-management function that accounts for the risks that the entity is assuming upon entering into their new venture. Auditors may want to assess management's depth and an institution's strategic plans when a client enters complicated, new areas of business.

**.27** Also, auditors should consider the need to apply certain auditing standards to their engagement, due to the entity's expansion into new products, services, or businesses. For example, if a finance company client ventures into insurance-related activities, the auditor should consider the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).

**.28** In addition, as stated in SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), auditors 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 or services; capital structure; related parties; locations; and production, distribution, and compensation methods. Auditors 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 their audits.

**.29 Increased Opportunity for Fraud.** Employees may have an increased opportunity to commit fraud, when financial institutions merge. With the restructuring and shake-ups taking place, employees can take



advantage of a breakdown in internal control, a lack of segregation of duties, and missing supervisory reviews to commit fraud. Furthermore, some employees become embittered after a merger. An employee's honesty can be influenced by an embittered attitude, motivating a rationalization to commit fraud.

.30 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 fraud risk factors that relate to both (a) misstatements arising from fraudulent financial reporting and (b) misstatements arising from misappropriation of assets in each of the related categories presented in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316.16 and .18).

.31 In implementing SAS No. 82, auditors can consult the AICPA's publication titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883). This publication contains example fraud risk factors specifically developed for financial institutions. Call the AICPA Order Department at 1-888-777-7077 to order.

#### **Executive Summary—Fundamental Changes in the Financial Services World**

- The financial services industry is changing rapidly and fundamentally. All kinds of financial institutions are involved in sweeping mergers and acquisitions across the country and worldwide.
- Certain conditions exist that make the time ripe for institutions to combine.
- Merged institutions and the nation face many challenges; however, the merger mania presents opportunities for mid- and small-sized institutions.
- Auditors may need to address a variety of issues when institutions merge, including accounting for the merger and acquisition; accounting for restructuring charges; internal control weaknesses; the effects of adding and expanding product lines, services, and businesses; and increased opportunity for fraud.

### **Industry Financial Performance**

*How has the depository institutions and lending industry been generally performing?*

.32 Financial institutions, for the most part, have been performing well. Earnings, profits, return on equity, and return on assets have all flourished at many institutions. The larger institutions within the industry have grown the fastest. The number of troubled institutions and failed institutions is remarkably low, and loan delinquency problems are less worrisome. However, a number of large financial institutions have recorded substantial losses recently due to the economic troubles spreading through the world. Trading in the securities of, and bad loans to, economically troubled nations are the reasons behind the losses. Financial institutions' ability to maintain impressive operating results could be challenged by the global financial crisis and a possible economic slowdown at home, if the U.S. economy fails to perform at its robust pace. In fact, signs of a credit crunch affecting larger commercial entities are appearing, as financial institutions may be assuming a more cautious approach when lending to riskier borrowers. (See the "Global Economic Crisis" section of this Alert for further information.) Following are some brief discussions about the financial performance of some specific areas of the industry. In addition, readers should also read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a discussion of the general U.S. economy.

#### **Thrifts**

.33 The thrift industry has posted increased earnings and improved return on assets. These positive results are attributable to a strong economy and record home sales and housing starts. The core business of the thrift industry remains home loans, even though many thrifts have diversified into consumer lending and commercial lending. Profit margins on the home loan business are thin, which contributes to the consolidation taking place in the industry. In addition to increased earnings, the thrift industry has also raised

its asset levels, although this has occurred mostly at large thrifts. The thrift industry will not find it easy to maintain its track record of increased earnings due to slowing home sales and fewer refinancings of existing mortgages.

### ***Credit Unions***

.34 Credit unions have generally shown growth in most performance categories. Earnings, membership, and assets have increased. Credit unions have also experienced strong loan growth, including first mortgage loans, used auto loans, and other real estate loans. Larger credit unions have tended to post better earnings improvements than smaller credit unions, due partly to relatively higher operating expenses at smaller credit unions. Larger credit unions tend to have better economies of scale than do smaller credit unions. As a result, smaller credit unions offset the higher operating expenses with slightly lower cost of funds.

### ***Commercial Banks***

.35 The commercial bank sector has for the most part recorded sizeable increases in earnings, profits, return on assets, and return on equity. The major factor fueling this strong performance is fee income. These fees come from many sources, including—

- Mortgage origination and servicing
- Trust services
- Asset management
- Fund transfers
- Traditional deposit service
- Credit cards
- Investment banking
- Securities servicing

Other factors contributing to the industry's improved performance have been the introduction of cost-control initiatives at numerous banks and a tendency to better utilize capital.

.36 Commercial banks have experienced moderate loan growth during 1998. Furthermore, loan growth comprises more loans to businesses and fewer to consumers, as solid profits at corporations and businesses are generating demand for loans.

.37 As mentioned above, some large banks have incurred significant trading losses and loan impairment losses, as a result of the economic turmoil around the world and volatile global financial markets. If severe enough, these losses may lead to layoffs and restructurings at some institutions.

### ***Community Banks***

.38 Community banks generally have also been performing well. Their solid performance is largely attributable to strong local economies that have sparked excellent loan growth at the banks and have sparked a notable proliferation of new community bank starts. In contrast to the positive news, community banks are experiencing diminishing deposit levels, which has raised concern in the industry. See the "Dwindling Deposits" section of this Alert for more information on that issue.

### ***Credit Card Issuers***

.39 The chargeoff crisis of the previous year seems to have ended for many credit card issuers. The latest reports indicate that late payments on credit card balances and chargeoffs of balances have declined drama-

tically. This credit quality improvement is attributable to issuers' "get tough" stance on underwriting practices and aggressive collection efforts. Whether the credit quality of outstanding balances has truly improved remains to be seen; nevertheless, current indicators do point to a broad improvement in the quality of credit card balances.

### ***Mortgage Bankers and Home Equity Lenders***

.40 Mortgage bankers and home equity lenders have recorded remarkable loan-origination increases as interest rates remain very low and a resulting refinancing wave carries the industry. Subprime lenders are experiencing positive loan growth as well. These low interest rates and refinancings can be a double-edged sword, however. For every new loan originated in a refinancing, an old loan is repaid. Mortgage bankers and home equity lenders that rely on income from servicing loans have seen their servicing portfolios decline rapidly, as loans are prepaid. This can be a problem if the institution cannot originate new loans quickly enough to replace the lost volume. In addition, the massive refinancing prepayments have forced some lenders to record substantial write-downs of the original gains they recorded on loans that they securitized and sold. See the "Refinancing Rage, Prepayment Risk, and FASB Statement No. 125 Accounting" section of this Alert for more detailed information.

#### **Executive Summary—Industry Financial Performance**

- Generally, financial institutions have performed well recently, with strong earnings, profits, return on equity, and return on assets.
- Global economic turmoil is causing substantial losses at some large banks and threatening the future growth of the U.S. economy and the financial performance of the industry.
- Some community banks are experiencing diminishing deposit levels.
- A wave of refinancings and related loan prepayments is hitting the mortgage banking and home equity sectors.

### **Credit Risk: Loan Performance Bright, but Storm Clouds on the Horizon**

*What matters affecting credit risk should a CPA be aware of?*

.41 Loan performance in the industry is generally healthy, but credit problems may arise in the near future; indeed, some institutions are already experiencing credit problems. A vigorous overall U.S. economy has contributed to solid loan performance, but that same strong economic growth has also contributed to an easing of loan-underwriting standards. History teaches that underwriting standards usually decline during periods of economic prosperity, because of the fierce competition for borrowers and loans that strong economic growth engenders. If carried too far, the easing of terms can undermine an institution's financial health, especially if the economy weakens or the extraordinary recent performance of business profits and cash flows does not persist.

#### ***Easing of Underwriting Standards***

.42 The erosion of underwriting standards has occurred across almost all sectors of the industry, including commercial, industrial, consumer, mortgage, and home equity loans. Credit card issuers, however, have tightened their underwriting standards. The slippage in standards includes such items as—

- Fewer loan covenants
- Longer loan maturities
- A lack of future cash-flow projections
- An easing or lack of guarantees

- Relying too heavily on expected, rather than proven, cash flows
- Inadequate documentation of financial strength to support the loan

In addition, lenders are offering lower rates and lower fees in their competition to attract customers, which can diminish loan spreads. As a result, lenders receive too little compensation for the larger risks they are taking. Complacent from years of economic prosperity, many lenders are loosening repayment and recourse terms to compete effectively for loans.

.43 Adding to the underwriting concerns, a number of lenders have not been diligent in stress testing their loan portfolios and tracking their loan concentrations by industry and geographic area. Many lenders have not made proper assessments of how their loan portfolios would react to changing economic conditions in their areas and industries.

.44 Although not currently causing significant credit problems, the easing of underwriting standards and the other matters mentioned previously may bear bitter fruit when economic conditions sour. When economic conditions crumble, many consumers and businesses suffer under heavy debt loads that they find hard to repay. Loan losses can mount up rapidly when the good times stop rolling. Already, consumer bankruptcies have been soaring, and that can only worsen if the economy falters. Presented next are some brief overviews of certain specific loan sectors.

### *Subprime Lending*

.45 Subprime lending consists of lending to people with tarnished credit histories, low incomes, little or no experience in handling debt, and in lending money that far exceeds any underlying collateral. Subprime lending can involve various loan types, but the majority of the business comprises mortgage and home equity loans. This type of lending has been growing substantially, due to the fierce competition in the lending industry and to the desire to find new customers and sources of revenue to fuel an institution's financial performance. Subprime lending provides financial institutions with high profit margins, through higher fees and interest rates. Those benefits are accompanied by higher volatility and default rates, however.

.46 Given the increasing rate at which lenders are jumping into the subprime sector, concern exists over the credit risks involved. Consumer bankruptcies are at elevated levels, and many subprime borrowers have overextended credit lines, increasing the chances of defaulting. Other risks include the following:

- Lenders moving into this type of lending may not have the necessary expertise or understand fully the risks involved. Every type of subprime lending, whether it be auto loans or home equity lines of credit, requires its own unique expertise.
- Subprime borrowers are often loaded with debt. If local economic conditions deteriorate, those borrowers may lose their jobs or see their financial situations worsen. Consequently, they may not be able to pay their debts.
- In subprime lending, little or no collateral normally exists to cover bad loans.

.47 Another escalating form of subprime lending is high loan-to-value (LTV) loans. More and more, lenders are allowing customers to borrow money beyond the value of the underlying collateral, in some cases up to 150 percent of a home's worth. This is a risky form of lending insofar as the lender may suffer serious losses if the borrower is unable to keep up with the high loan payments. Here is a common example of the way high LTV loans are used:

A borrower has a large outstanding credit card balance. That borrower accepts a high LTV home equity loan from a financial institution. With the loan money, the borrower pays off the credit card balance and now has a loan outstanding. That situation is not necessarily a problem. What often happens, though, is the borrower goes out and runs up another large

credit card balance. Now the borrower has payments on the high LTV loan and payments on the credit card. If the borrower is overwhelmed by the debt payments and declares bankruptcy, the institution is left with two nonperforming loans.

One should also remember that in a high LTV situation, the amount of the loan that exceeds the value of the collateral is unsecured. As such, there are reporting and risk-based capital ramifications for the lender.

### ***Loans to REITs and Real Estate Entities***

.48 Loans to real estate investment trusts (REITs) and real estate entities have escalated sharply, in part due to a construction and real estate boom. Many REIT loans are unsecured, and typically they are large and syndicated. As with most other loan types, lenders have relaxed their underwriting standards on many loans to REITs and real estate loans, due to the intense competitive environment.

.49 Lenders should treat their REIT loans as part of their exposure to real estate. If real estate prices decline, the REITs will be hard-pressed to acquire enough cash to pay back their loans. Lenders should consider their REIT customers' ability to repay their loans if commercial real estate markets falter. Also, like the high LTV loans discussed above, REIT loans are often unsecured, thus triggering certain reporting and risk-based capital ramifications for the lender.

.50 No alarm is currently being sounded for real estate loans. However, the reduced underwriting standards could cause future problems, if the economy slows and commercial real estate markets suffer. Many real estate loans currently being made are speculative and are attached to construction projects that have few tenant or buyer commitments. If economic trouble arises, the people who constructed those buildings may not find tenants or buyers. Consequently, the real estate loan borrowers could end up defaulting on their loans. Lenders need to consider their borrowers' sources of payments, besides the construction project.

### ***Agricultural Loans***

.51 Serious financial problems are developing for farmers and ranchers, due to sinking commodity prices and severe weather problems in certain parts of the nation. Added to these problems is the reduced amount of exports due to the crisis in Asia and other parts of the world, which will cause many farmers and ranchers to earn substantially less money. Consequently, they may have difficulty paying back their loans and also will cut back on their business investments, reducing the amount of loans they would have otherwise taken from lenders.

.52 Most farmers and ranchers deal with community institutions for their loan needs. These institutions need to carefully monitor loans to farmers and ranchers who are affected by falling commodity prices and falling exports. Many of these community institutions may have risks related to concentrations of loans to farmers or ranchers in specific geographic areas.

### ***Steps for Lenders to Reduce Credit Risk***

.53 Lenders should consider different scenarios in evaluating their credit risks, for instance, how loans would perform if certain financial and economic conditions changed. Also, management should remember that many institutions have failed throughout history because of concentrations of loans in geographic areas and specific industries. Accordingly, management should be alert to possible economic trends in the areas and industries they serve. Moreover, lenders should resist any tendency to assume in evaluating loans that the unusually favorable economic environment of the last few years will continue indefinitely.

.54 Directors and senior management of financial institutions have the obligation to monitor lending practices and to ensure that their policies are enforced and that lending practices generally remain within the overall ability of the institution to manage.

.55 In addition to the aforementioned practices, lenders should—

- Ensure that they have the expertise to collect and work subprime accounts. Such collection expertise is crucial to successfully operating in the subprime business.
- Have rapid delinquency intervention processes, comprehensive counseling, and reduced layering of multiple risk factors in place.
- Base loan-loss allowances on probable credit losses that have been incurred as of the balance-sheet date, and not solely on what has happened in the past, or regulatory formulas.
- Maintain solid underwriting standards and base them on long-term strategic portfolio objectives and the level of risk an institution is willing to tolerate over the long run.

### ***Auditing Issues***

.56 When evaluating credit risk, the quality of loans, and the adequacy of loan-loss allowances, auditors should consider the matters discussed in this section and determine if there is a heightened level of risk on their clients due to those matters. It may be necessary to alter the nature, timing, and extent of audit procedures and increase the level of testing due to the matters mentioned in this section. In addition, auditors should be aware of the aforementioned practices that should be adopted by lenders and factor into the risk assessment and planned audit procedures the absence of any of those practices at their clients. The evaluation of loan quality and loss allowances is a complicated process. FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text*, vol. 1, sec. I08), and FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59), are the primary sources of guidance on accounting for loan losses. Also, auditors should read chapters 6 and 7 of the *Audit and Accounting Guide Banks and Savings Institutions*, chapters 5 and 6 of the *Audit and Accounting Guide Audits of Credit Unions*, and chapter 2 of the *Audit and Accounting Guide Audits of Finance Companies*, as applicable, for a thorough discussion of auditing procedures regarding loans and loan-loss allowances.

#### **Executive Summary—Credit Risk: Loan Performance Bright, but Storm Clouds on the Horizon**

- Loan performance in the industry is healthy, but credit problems may arise in the near future.
- There have been a general easing of underwriting standards and an increase in risky subprime lending. Also, farmers and ranchers may be facing problems that could affect their ability to repay their loans.
- Auditors may want to look carefully at underwriting standards, subprime lending, and the types of customers with outstanding loans, in determining the nature, timing, and extent of audit procedures related to loans and loan allowances.

### **Global Economic Crisis**

*What, briefly, are these global economic problems all about  
and how do they affect financial institutions?*

.57 A global financial and economic crisis is shaping up that could be one of the most exacting economic shocks of the century. Beginning in the foreign exchange markets and mushrooming into the banking sector of Asia, this crisis has spread to Russia and Latin America and is threatening to destabilize the European and American economies. A global recession may result, with serious implications for U.S. financial institutions and corporations.

#### ***Asia***

.58 In Asia, the Japanese economy has been suffering in a prolonged recession that has dragged down the economies of other Asian nations. The Japanese yen has sunk to very low levels, and the Japanese stock

market continues to lose value. In addition, the Japanese banking system is unstable, as it sits atop significant sums of bad loans. These banks have responded to their financial difficulties by withdrawing credit lines from other Asian nations, which has caused further financial distress in those countries.

.59 Outside of Japan, the currencies and stock markets of Asian nations continue to fall. Countries such as Indonesia, the Republic of Korea (ROK), Thailand, and Malaysia are experiencing severe currency devaluations, recession, unemployment, plummeting capital markets, dried-up credit sources, and falling consumption. China is under pressure to devalue its currency, the yuan, because its exports are being undercut by exports from the other Asian nations whose currencies are lower. A devaluation of the yuan would most likely trigger a devaluation in the Hong Kong dollar and a further round of currency devaluations in the area, thus worsening the situation.

.60 As Asian currencies lose value, those nations and the companies in those nations cannot buy enough U.S. dollars to pay off their U.S. dollar-denominated loans. Defaults and bankruptcies may occur. This would worsen the recession in those Asian countries, worsen the banking crisis in Japan, and could trigger a banking crisis in Europe, whose financial institutions are much more exposed in Asia than U.S. institutions.

### *Russia*

.61 The Russian economy has completely crashed. Its currency has been tremendously devalued and a large chunk of its economy is operating on a barter system. In addition, the current oil glut and low oil prices have substantially reduced very important oil revenues to Russia. The devaluation of the Russian ruble has spread panic throughout other emerging markets, such as Latin America. The Russian government is mired in a state of chaos and has refused to pay some of its foreign debts. In fact, large-scale debt restructurings will be necessary. All of this has led to a complete loss of investor confidence in Russia and has led to shakiness in Western and other financial markets, as a nuclear-armed, unpredictable, and chaotic Russia continues to implode.

### *Europe*

.62 The Russian financial and economic collapse will detrimentally affect the economies of former Soviet republics and the Baltic states, given their dependence on the Russian economy. Moreover, the Russian crisis may drag down Eastern European countries such as Poland and the Czech Republic.

.63 In Western Europe, economic malaise and high unemployment continue. The financial crisis in Russia and other emerging markets will slow the economic recovery of Western European countries. Already, the German and Spanish stock markets have tumbled as a result of the Russian collapse.

### *Latin America*

.64 The problems in Asia and Russia have spread to the emerging markets of Latin America, and investors have begun pulling out of those markets. The economies of Latin America have already been struggling with difficulties, such as low exports and low commodities (for example, oil) prices. Now, with investors pulling out, capital sources will become scarcer. In addition, a wave of currency devaluations could hit Latin American nations, because they may have to devalue their currencies to not lose exports to Asian nations, whose currencies are already low.

### *Hedge Funds*

.65 The rapidly deteriorating conditions in world financial markets have hit some hedge funds particularly hard. Hedge funds typically engage in complex trading strategies. Such strategies, designed to hedge investors from changes in currency and interest rates, require traders to predict the direction of those changes. Many of those strategies were proven woefully inadequate when confronted with the volatile global financial

situation. As these investments broke down, hedge fund operators struggled to meet the demand for investor redemptions and margin calls from lenders who had financed these investments, dumping their holdings and incurring huge losses. Firms that used leverage to make hedges magnified those losses. In one highly publicized case, the Federal Reserve Bank organized a \$3.6 billion private bailout of Long-Term Capital Management Fund, a large hedge fund with an estimated \$1.25 trillion exposure to international markets. The Federal Reserve Bank feared that the fund's imminent collapse would further damage world markets.

### *Effects of Currency Devaluations*

.66 When currencies devalue, the price of imported goods increases, which causes inflation to rise. Also, institutions and companies that borrowed in U.S. dollars pay out more money in local currencies, when the local currency devalues. Some of these institutions and companies may default and go bankrupt. Investors suffer, since they cannot retrieve their money. In addition, the local economies worsen, with increased unemployment and recession.

### *What Caused the Current Crisis*

.67 The causes of the global financial and economic crisis are complicated and numerous. The International Monetary Fund (IMF), a primary agency of the global economy, has continually bailed out the bankrupt countries of the emerging markets with massive loans. These countries are not forced to undergo market-induced reforms of their aberrant economic and financial structures and markets. As a result, no real fundamental reform occurs in those countries and the underlying problems remain. For example, the financial and political institutions and processes in Russia have not fundamentally changed since the Soviet Union lost the cold war in 1991. Western governments have poured massive amounts of loans into Russia. These bailouts have kept a dysfunctional and discredited system on life support.

.68 Often, the massive loans made to these emerging markets are never repaid, currency devaluations become widespread, and economies hurtle into recession.

.69 The crisis is also the result of inordinate and imprudent investments in and loans to unprofitable businesses, real estate developers, pampered state enterprises, and other projects. Additionally, the crisis is due to a decades-old reluctance by Asian nations, especially Japan, to allow more foreign access to its markets and foreign equity ownership of its corporations.

### *Solutions*

.70 Currently, the countries embroiled in the crisis and the Western nations do not know how to solve this global problem. The governments of the Asian nations, and the other nations similarly affected, are constrained to clean up the financial mess and institute radical reforms. They need to ensure that draconian measures, writing off large nonperforming loans and reorganizing or closing problem institutions, are introduced. In fact, Asian governments, such as those in Thailand, ROK, and Japan, have instituted reform programs.

.71 The emerging market nations immersed in this crisis may not succeed in reforming their financial and economic infrastructures. There is always the tendency to conceal bad loans, and political pressures may prevent necessary reforms. For instance, powerful constituencies in those nations fear the changes that financial reform will bring and may attempt to stymie those changes. Also, immense amounts of public money are needed to write off the many bad loans, and large layoffs may result from the restructuring of businesses and institutions. Those measures will create a tremendous uproar among the populations of those countries. Riots, such as those in Indonesia, are a real possibility.

.72 How long the crisis will last and how much worse it will get is impossible to predict. Too many variables are involved, and the problems are too complicated.



### *Effects on the United States*

.73 Instability in foreign countries affects the American economy, financial institutions, and companies. Some of the effects of the global crisis on the United States could be perceived as beneficial. For instance, the Federal Reserve has refused to raise interest rates, due in no small part to the Asian turmoil, since the Fed does not want to trigger further currency devaluations. Lower interest rates have boosted home building, commercial construction, and consumer spending. The negative effects of the global crisis, however, could far outweigh any perceived positive effects. Miserable economic conditions in emerging market countries and a strong U.S. dollar can be seriously detrimental to U.S. corporations, by causing a decline in demand for U.S. goods and slow domestic sales, due to competition from cheaper imports. Also, financial institutions and companies that have links or are thought to have links to those countries embroiled in the financial turmoil may see their stock prices lose substantial value, as investors run away from such entities. Some economists predict that the full effect of the global troubles will strike the U.S. in early 1999. The effects of the crisis will be varied across the country. Manufacturers, oil producers, ranchers, farmers, high-technology companies, and aerospace businesses that rely on exports may be seriously affected.

.74 In particular, the Western U.S., including California, Idaho, Arizona, Oregon, and Washington, is much more heavily dependent on Asian exports than other parts of the country. Grain-producing states in the Great Plains and Midwest also rely on Asian markets to sell their agricultural products. States such as Texas, Arkansas, and Oklahoma may suffer economic slowdowns due to dwindling oil exports to Asia. In addition, Hawaii could experience a decline in the tourism industry, as fewer Asians are able to travel due to harsh financial conditions.

### *Effects of the Global Crisis on Financial Institutions*

.75 Borrowers whose businesses are adversely affected by the global crisis, such as farmers, ranchers, and manufacturers, may be under stress to repay their debts, as their revenue and profits decline. Management of financial institutions will need to carefully monitor the loan portfolios of those borrowers. Furthermore, people who are employed in industries whose production levels are slowed by the global financial disaster may face unemployment or reduced wages. These people will also be under stress to repay their outstanding debts. Management will therefore need to carefully monitor the performance of those loans.

.76 Larger international financial institutions are suffering large losses due to bad loans and trading setbacks. Many of these institutions will most likely see the quality of their assets and derivatives in Russia, Asia, and other troubled areas deteriorate. Consequently, material chargeoffs of those assets and derivatives may be necessary. In some cases, losses at some institutions may be significant enough to trigger layoffs and restructurings.

.77 In addition to the loan-quality problems just mentioned, financial institutions could face reduced levels of business growth, including fewer commercial loans, if the effect of the global crisis is severe enough to seriously slow U.S. economic growth.

### *Auditing Issues*

.78 As mentioned above, lenders may be confronted with a deterioration in the quality of their loans to customers adversely affected by the global financial and economic crisis. Auditors should be aware of these worldwide financial troubles and whether their clients' loan portfolios are affected. Auditors should read the "Credit Risk: Loan Performance Bright, but Storm Clouds on the Horizon" section of this Alert for guidance on steps to take regarding loan-quality evaluations.

.79 Also, greater risk exists with institutions involved in derivatives, assets, and foreign-currency-related transactions related to troubled countries. Based on the materiality of the amounts involved, auditors may need to determine whether management has appropriately assessed the performance of its assets and deri-

vatives related to Asia, and whether such balances should be charged off. Also, auditors should consider whether management has appropriately accounted for, and made all required disclosures relating to, foreign currency translation, transactions arising from the translation of asset and liability positions, and revenue and expense transactions in currencies other than the U.S. dollar pursuant to FASB Statement No. 52, *Foreign Currency* (FASB, *Current Text*, vol. 1, sec. F60).

.80 The global crisis may also result in a greater number of risks and uncertainties for many institutions, particularly with regard to current vulnerability due to certain concentrations. Auditors should consider whether management has appropriately evaluated all such risks and uncertainties and made the necessary disclosures pursuant to Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition, auditors should also evaluate management's consideration of related contingencies arising from the global crisis, pursuant to FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59).

.81 These are just some examples of some of the possible auditing and accounting implications of the global economic crisis and should not be viewed as an exhaustive list of all the issues that might arise. Auditors should continue to monitor the crisis and assess its impact on their clients, considering all relevant facts and circumstances.

#### **Executive Summary—Global Economic Crisis**

- A global economic and financial crisis exists that is affecting emerging markets, such as Asia and Russia. The crisis involves currency devaluations, loan defaults, and severe recession.
- The causes of the crisis are complicated and numerous. They include poor policy decisions by the IMF and Western governments, and inordinate and imprudent investments and loans.
- Financial institutions may suffer from the crisis in a variety of ways, including the possible financial deterioration of borrowers, losses on trading and loan activity connected to troubled nations, and lower demand for loans by businesses and people adversely affected by the crisis.
- Auditors should be aware of the potential risks to institutions that have loans and derivative transactions with institutions and governments in those countries affected by the crisis. In addition, auditors should pay attention to the credit quality of loans to people and businesses affected by the global crisis, such as businesses that export goods to Asia.

### **SEC Staff Views on Provisions for Credit Losses**

#### *What is the SEC saying about provisions for credit losses?*

.82 The SEC staff believes that obligations for credit losses on certain off-balance-sheet financial instruments (for example, forwards and swaps) should be classified separately as liabilities and not combined with the allowance for loan losses. In addition, for on-balance-sheet financial instruments, allowances for credit losses are valuation accounts that should be presented as a reduction of the carrying value of the related balance-sheet item. That is, the allowance for credit losses for different balance-sheet instruments may not be aggregated and presented on a separate stand-alone basis in the balance sheet.

.83 As to the treatment of the provisions for credit losses in the income statement, article 9 of Regulation S-X indicates that the provision for loan losses should appear on the face of the income statement or in the notes. This item is included in the amount reported as net interest income after provision for loan losses and is before other income and other expenses. Based on its account title in article 9 and its relation to net interest income in the income statement, the SEC staff does not believe that it is appropriate for credit loss provisions on other types of balance-sheet and off-balance-sheet items that do not affect net interest income to be included in the provision for loan losses account. The staff believes that these other provisions should be recorded in other income and expenses. In addition, the SEC staff believes that it is inappropriate to transfer general reserve amounts between the different allowance accounts established for credit losses.

## Credit Union Membership Legislation

*What has resulted from the huge legislative battle over credit union membership?*

.84 On August 7, 1998, legislation was signed into law that eases membership restrictions on credit unions and allows them to expand. The legislation, known as H.R. 1151, The Credit Union Membership Access Act, will permit occupation-based credit unions to take in groups of members from unrelated companies, as long as each group has fewer than 3,000 employees.

.85 The passage of this legislation negates a February 1998 Supreme Court ruling that restricted credit union membership and ended the expansion considered critical to the credit union industry. Siding with banks, the Supreme Court decided that the current law required credit unions to serve members joined by a single common bond, not multiple groups, each with its own common bond. However, Congress, largely sympathetic to credit unions and their millions of members, changed that law.

## Auditing Issues

.86 H.R. 1151 includes credit union audit provisions. The need for those provisions arose because the National Credit Union Association (NCUA) adopted a regulation that allows nonlicensed persons to audit a federal credit union's financial information. This is in direct contravention of most state accountancy statutes. The credit union audit provisions of H.R. 1151 require—

1. Insured credit unions with assets greater than \$10 million to file reports or statements with the NCUA that are consistent with generally accepted accounting principles (GAAP), or are no less stringent than GAAP.
2. Insured credit unions with assets greater than \$500 million to have annual independent audits of their financial statements performed in accordance with generally accepted auditing standards (GAAS) by independent CPAs or licensed public accountants.
3. Federal credit unions with assets greater than \$10 million, that use an independent auditor to perform the audit required by the credit union supervisory committee, to use an auditor licensed pursuant to the state accountancy statute.

CPAs engaged with credit unions facing the new GAAP requirements should obtain a copy of the AICPA's Audit and Accounting Guide *Audits of Credit Unions* for an understanding of the financial accounting and reporting principles and practices for credit unions. The Guide can be ordered by calling the AICPA Order Department at 1-888-777-7077

## Modernizing the Country's Financial Framework

*What efforts are under way to update the nation's laws and regulations governing her financial institutions?*

## Current Legislative Efforts

.87 Many believe that financial modernization legislation is needed to create an effective legal framework for financial institutions and other financial services companies to operate and compete in. The current legal framework has been rendered largely obsolete by the rapid changes occurring in the financial services industry (see the "Fundamental Changes in the Financial Services World" section of this Alert for more information) and by aggressive regulatory changes. Legislation may be needed to ensure that all financial institutions are given the chance to compete in many different financial services on a level playing field.

.88 The Senate is currently debating legislation (H.R. 10) that significantly reforms the laws governing the activities of financial institutions. The bill was passed by a one-vote margin in the House of Representatives on May 14, 1998. As it stands, H.R. 10 allows banks, securities firms, and insurance companies to

merge and operate as affiliates under a financial holding company, supervised by the Federal Reserve Board (the "Fed"). Among other provisions, this legislation allows banks to underwrite securities and insurance through affiliates and codifies the insurance and securities activities that financial institutions have already been engaging in.

.89 If eventually passed into law, H.R. 10 would eliminate the Glass-Steagall Act, passed in 1933 during the Great Depression to prevent abusive activities by banks. The Act prohibits commercial banks from dealing in or underwriting securities. Regulators, especially the Office of the Comptroller of the Currency (OCC), have been eroding the restrictions of the Glass-Steagall Act for years. Many analysts believe that Glass-Steagall is no longer necessary, as the abuses it was meant to prevent are now illegal. Furthermore, financial institutions have simply outgrown the antiquated restrictions placed on their activities in nonbanking areas. Barriers between banking and insurance activities were erected in the mid 1950s. H.R. 10 would eliminate those barriers as well by allowing banks to underwrite insurance.

### *Support for and Opposition to the Current Legislation*

.90 H.R. 10's prospects for passage into law are not bright. Many powerful interests oppose the bill as currently written. Those interests include a majority of the banking industry, the Treasury Department, and groups that claim to represent consumers. The securities industry, the insurance industry, and the Fed support the bill.

.91 Some analysts see the disagreement between the Treasury Department and the Fed over the bill as a turf war. H.R. 10 requires financial institutions to operate their securities and insurance businesses in holding company affiliates. These affiliates would fall under the supervision of the Fed. The Treasury Department, whose regulatory arm is the OCC, wants securities and insurance activities to be housed in operating subsidiaries, where they hold regulatory sway.

.92 Beyond a simple turf war, serious concerns exist over whether the Fed or the OCC should have primary supervision over banks' new business activities. For instance, H.R. 10's requirement that banks' insurance and securities businesses operate out of holding companies would insulate those activities from bank activities insured under the Federal Deposit Insurance Corporation (FDIC). In contrast, if insurance and securities businesses are housed in bank operating subsidiaries, then such businesses would in effect be subsidized by FDIC insurance. Banks would therefore maintain an unfair advantage over their nonbank competitors, and the FDIC insurance system would be exposed to possible failures in those activities. In addition, the Fed is an independent agency, whereas the OCC is part of the executive branch of the government. As such, allowing the OCC to maintain primary supervision would result in the potentially dangerous situation of having politicians regulate a significant amount of the banking industry.

.93 Banks dislike the current bill because they believe it contains muddled provisions that limit their ability to engage in insurance activities. They also oppose the bill's provisions that give securities and insurance regulators authority over banking products. In addition, banks oppose the bill because it diminishes the capacity of national banks to operate businesses from operating subsidiaries, because H.R. 10 would have banks operate their securities and insurance activities from holding companies. These holding company affiliates are expensive to create and, as discussed earlier, would be regulated by the Fed and not the OCC. Banks favor OCC supervision inasmuch as the OCC has broadened the powers of banks to expand into new business areas during these changing times. Smaller banks oppose H.R. 10 mostly because they believe the bill will help very large financial institutions expand and threaten their business.

.94 Some groups claiming to represent consumers have brought considerable pressure to bear on legislators in hopes of defeating or changing H.R. 10. Their primary fear is that the bill's shifting of a bank's activities to holding company affiliates would weaken the Community Reinvestment Act (CRA). Bank holding affiliates are not subject to the CRA's provisions. Thrift institutions oppose H.R. 10 legislation because they believe the bill would restrict the powers of thrifts and weaken their competitive standing in the industry.

.95 Insurance company management and management of securities firms are ardent supporters of H.R. 10, believing that the bill levels the playing field on which they compete against banks and other financial institutions.

.96 Auditors should monitor the development of financial-modernization efforts, inasmuch as new laws governing the activities of financial institutions will obviously have a significant effect on clients that engage in lending and depository activities.

#### **Executive Summary—Modernizing the Country's Financial Framework**

- Congress is debating important and historic legislation that would change the laws and regulations that govern the activities of financial institutions.
- The prospects for passage of this legislation are not bright. Many powerful interests oppose the bill.
- Auditors should keep abreast of developments.

### **Management Under Pressure and Possible Audit Risk**

*Is management of financial institution clients subject to unusual stresses these days?*

.97 Although management of financial institutions is always under pressure to perform, the circumstances that exist currently may be more strenuous than usual. Some of those circumstances are described in the following sections.

#### **Earnings Expectations**

.98 Management of financial institutions has been under unusual pressure to release earnings statements that meet analysts' expectations. If management does not report such earnings, the market value of the institution's stock decreases and management normally suffers.

#### **Merger Expectations**

.99 Management of institutions that have combined during this current consolidation trend is under stress to justify the combination to shareholders by delivering the promised fruits of those mergers—such as reduced expenses, expanded product lines, expanded product channels, synergies, and improved profit margins. Management may find it quite difficult and distressing to make these mergers and acquisitions work and keep shareholders happy. See the "Fundamental Changes in the Financial Services World" section of this Alert for a further discussion.

#### **Fierce Competition**

.100 Competition within the financial services industry is especially fierce these days, as the consolidation and convergence mania demonstrates. This intense competition is forcing financial institutions to battle for all types of loans and deposits by offering better service and more attractive interest rates to customers. No sector within the industry seems untouched by this heightened level of rivalry. Some examples of this competition follow.

- Community banks and credit unions are competing for deposits and consumer loans within a similar area and with large multi-state banking organizations.
- Financial institutions are vying among themselves and with mutual funds and insurance companies for deposit dollars.
- Commercial banks contend with insurance companies in expanding their operations to include asset management businesses and annuity products.

- Several insurance companies have applied for thrift charters, in hopes of lending money to their policyholders, thus posing another competitive threat to traditional lenders.
- Many credit card issuers must offer incentives, such as low teaser rates, no annual fees, balance transfer options, and rebates to attract new customers.
- Home equity lenders have struggled furiously to take customers away from one another by offering lower rates or bigger loans, in a tremendous round of refinancings.

### ***Auditing Issues***

**.101** Some specific matters auditors should be concerned with, when auditing a client subject to intense pressures, include the risk of material misstatement due to fraud, possible loan-quality issues, liquidity, aggressive accounting methods, and internal-control weaknesses.

**.102 *Risk of Material Misstatement Due to Fraud.*** SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, points out the following factors that may indicate an increased risk of fraudulent financial reporting at the institution:

- 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
- A management practice of committing to analysts, creditors, and other third parties to achieve what appear to be unduly aggressive or clearly unrealistic forecasts
- Management setting unduly aggressive financial targets and expectations for operating personnel
- High turnover of senior management, counsel, or board members
- High degree of competition or market saturation, accompanied by declining margins
- Rapid changes in the industry
- Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity
- Unrealistically aggressive sales or profitability incentive programs
- Adverse consequences on significant pending transactions, such as a business combination, if poor financial results are reported

When one or more of these risk factors is identified, professional judgment should be exercised when assessing their significance and relevance. Auditors assessing the risk of material misstatement due to fraud should keep in mind that the presence of a risk factor should not be considered in isolation, but rather in combination with other risk factors and conditions or mitigating circumstances. SAS No. 82 provides guidance to the auditor when considering risk factors in assessing the risk of material misstatement of the financial statements due to fraud.

**.103 *Loan Quality Issues.*** Some lenders choose to combat the intense competitive pressures by sacrificing loan quality to achieve desired levels of volume. These lenders may relax underwriting standards to gain market share. Read the "Credit Risk" section of this Alert for guidance regarding loan-quality issues.

**.104 *Liquidity.*** As pressure increases to maintain or expand earnings, the institution may sacrifice liquidity by seeking investments and loans with higher risks and returns. If market interest rates subsequently increase, the value of the investment portfolio, held for liquidity purposes, will decline.

**.105 *Aggressive Accounting.*** To achieve expected results or report improved financial results, management may adopt aggressive accounting positions. For example, management may be unusually aggressive

in recognizing income related to complicated lending arrangements or capital-markets transactions. Perhaps management may establish excessive reserves in good times to be used during a downturn. Another example would be an unusually aggressive interpretation of authoritative guidance related to hedge accounting. Auditors should be alert to aggressive accounting positions taken by management and determine whether the accounting is appropriate under the circumstances.

**.106 *Overriding Internal Control.*** Management of financial institutions engaged in a severely competitive environment may aggressively engage in transactions and bypass normal internal control. For instance, a financial institution aggressively pursuing the home-mortgage loan business may risk originating loans that do not properly flow through the institution's lending-approval system, by exceeding credit limits, skipping certain approvals, or failing to collect adequate loan documentation. Internal control may therefore not be operating effectively, and loan quality problems may arise. If auditors determine that there is a risk of this occurring, they will need to take this into account in their consideration of internal control and perhaps increase control testing, such as additional inspections of loan documents. Poor internal control over loan origination may necessitate more test work in assessing the adequacy of the allowance for loan losses. In such instances, the auditor will want to make extensive management letter comments about controls over loans. The auditor may wish to recommend an examination of, or an agreed-upon procedures engagement on, internal control.

**Executive Summary—Management Under Pressure and Possible Audit Risk**

- Management is under unusual pressure stemming from earnings expectations, merger expectations, and fierce competition.
- Auditors should be aware of the risks involved when that kind of management pressure exists. Those risks include motivation to commit fraud, loan-quality issues, liquidity, aggressive accounting, and the potential to override internal control.

## Financial Institutions and the Year 2000

### *What is the Year 2000 Issue and how will it affect financial institutions?*

**.107** The inability of most computer programs to distinguish the year 1900 from the year 2000 poses substantial risks to all financial institutions. The majority of computer operating systems and programs currently in use have six-digit date fields (YY/MM/DD), which represent, for example, December 31, 1999, by 99/12/31. The six-digit field, with only two digits for the year, is the basis for all date-related calculations within most computer systems today, particularly mainframes. The fundamental problem posed for these systems by the arrival of the year 2000 is that they have no way of expressing a date past year-end 1999; 00/01/01 will be interpreted by them as January 1, 1900.

**.108** The year 2000 problem is pervasive and complex. Virtually every organization will have its computing operations affected in some way by the rollover of the two-digit year value to 00. Financial institutions, service providers, and vendors need to address the risks associated with the coming millennium. Assuring that computer systems and applications are year 2000-compliant presents a complex managerial and technological challenge for all institutions, both public and private. Achieving year 2000 compliance in mission-critical systems is essential not only for maintaining the quality and continuity of services, but also for assuring the very survival of the entity itself.

**.109** The year 2000 is not only an information systems issue, but also an enterprise-wide challenge that must be addressed at the very highest level of a financial institution. Senior management and the board of directors should actively manage efforts to plan, allocate resources, and monitor progress to correct year 2000 problems.

.110 The federal banking agencies have undertaken extensive supervisory efforts to make sure that financial institutions understand their obligation to be ready for the century date change and that they take the necessary steps to achieve year 2000 compliance. Many policy statements and advisory letters have been issued by the Federal Financial Institutions Examination Council (FFIEC) and the federal agencies addressing the year 2000. These documents can be obtained at the Web sites of the various agencies. See the "Information Sources" section at the end of this Alert for Web site addresses.

### ***Some Important Year 2000 Considerations***

.111 ***Creditworthiness of Borrowers.*** The approach of the year 2000 creates potentially adverse effects on the creditworthiness of borrowers. The credit quality of a loan may be affected by the failure of a borrower's operating or other systems as a consequence of a Year 2000 Issue or a borrower's failure to comply with debt covenant terms regarding Year 2000 Issues. An institution's allowances for loan losses, however, should be provided only for losses incurred as of the balance-sheet date, and should not be based on the effects of future events. Financial institutions should develop processes to identify, assess, and control the potential year 2000 credit risk in their lending and investment portfolios.

.112 ***Contingency Planning.*** Year 2000 contingency planning is needed to provide assurance that an institution's mission-critical functions will continue if one or more systems fail. The board of directors and senior management of a financial institution should ensure that their institution's year 2000 contingency-planning process encompasses a plan of action should there be systems failures at critical dates. Contingency planning must take into account the impact of external systems, including those of service providers, other financial institutions, customers, business partners, and infrastructure providers. Contingency planning will vary depending on the size and complexity of the financial institution. Every institution must evaluate its own unique circumstances and environment to develop a comprehensive plan to ensure its ability to continue as a functioning business entity after January 1, 2000.

.113 The FFIEC has issued an interagency statement titled "Guidance Concerning Contingency Planning in Connection with Year 2000 Readiness." Readers can obtain this document at the FFIEC Web site, at [www.ffiec.gov/y2k/contplan.htm](http://www.ffiec.gov/y2k/contplan.htm).

.114 ***Customer Awareness.*** Customers will look to financial institutions for assurances that the institutions are taking appropriate steps to prepare for the century date change. Financial institutions should consider the types of customers with whom they need to communicate and develop appropriate ways of reaching their customers. In developing customer awareness programs, financial institutions should consider some of the issues customers might be interested in discussing and effectively communicate with them about what could happen and what they should do if problems arise. The FFIEC has issued an interagency statement titled "Guidance on Year 2000 Customer Awareness Programs." Readers can obtain this document at the FFIEC Web site, at [www.ffiec.gov](http://www.ffiec.gov).

.115 ***Service Providers and Software Vendors.*** Many financial institutions use the services of information systems service providers and software vendors in operating critical business functions and, as a result, are relying on these entities to ensure that their products operate correctly after the century date change. Also, U.S. financial institutions are vulnerable to unprepared foreign institutions and businesses that seriously lag the U.S. in year 2000 preparedness. Even though the U.S. entity is year 2000 compliant, the foreign entity it is doing business with may not be, thus posing a risk to the U.S. institution.

.116 Financial institutions relying on vendors for information-processing services or products should establish a process to determine their vendors' progress in resolving year 2000 issues and the readiness of their own systems and data for appropriate testing. This process should enable an institution's management to identify the obligations of the institution and its service providers and software vendors, to establish an effective monitoring program of the renovation phase, to establish a process for testing the renovated pro-



ducts and services, and to adopt contingency plans in the event of information systems disruptions. The FFIEC has issued an interagency policy statement titled “Guidance Concerning Institution Due Diligence in Connection with Service Provider and Software Vendor Year 2000 Readiness.” Readers can obtain this document at the FFIEC Web site, at [www.ffiec.gov/y2k/vendor.htm](http://www.ffiec.gov/y2k/vendor.htm).

### ***Auditing Issues***

.117 First, it must be understood that it is the responsibility of an institution’s management—not of the auditor—to assess and remedy the effects of the Year 2000 on an institution’s systems. The year 2000 does not create additional responsibilities for the auditor. Under GAAS, 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. Thus, the auditor’s responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the year 2000 or by some other cause.

.118 Many auditing and accounting issues exist related to the Year 2000 Issue, including audit planning, going concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. These issues are fully discussed in the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. Auditors should be aware of these auditing and accounting issues and should understand the various auditing and accounting guidance that has been issued on the Year 2000 Issue.

.119 The Appendix to this Alert contains informative year 2000 question-and-answer guidance that CPAs will find helpful in understanding the issue and their responsibilities.

#### **Executive Summary—Financial Institutions and the Year 2000**

- The inability of most computer programs to distinguish the year 1900 from the year 2000 poses substantial risk to all financial institutions. Achieving year 2000 compliance in mission-critical systems is essential.
- The federal banking agencies have undertaken extensive supervisory efforts to make sure that financial institutions achieve year 2000 compliance. Many policy statements and advisory letters have been issued.
- Some year 2000 considerations include the creditworthiness of borrowers, contingency planning, customer awareness, and the readiness of service providers and software vendors.
- Auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a thorough description of audit issues. Also, the Appendix to this Alert contains helpful year 2000 question-and-answer guidance.

### **European Economic and Monetary Union**

#### ***What are EMU and the Euro all about?***

.120 On May 2, 1998, eleven of the fifteen countries constituting the European Union (EU) formally elected to enter Economic and Monetary Union (EMU) on January 1, 1999. The advent of EMU is an international event of a singular magnitude, with far-reaching implications for companies that conduct trade and business in and with Europe, and for the international financial industry. Considered to be the biggest economic event in Europe in the past quarter century, EMU will introduce only one reporting currency for Europe—the Euro. In addition, the European Central Bank (ECB) will become operational on January 1, 1999.

.121 The eleven founding countries of EMU are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain. Greece anticipates joining in 2001, and Denmark, Great Britain, and Sweden have elected to stay out of EMU for the time being.

### *How EMU Works*

.122 The establishment of the Euro as the single currency of the eleven countries will occur over a three-year period, from January 1, 1999, to July 1, 2002. At first, over the long holiday weekend of December 31, 1998, through January 4, 1999, all the currencies of the eleven European nations will be converted to the Euro at rates locked in on December 31, 1998. Cross-currency exchange rates between the countries (for example French francs to Belgian francs) will no longer exist. Only one conversion rate will be published—national currencies to the Euro. During the next three years, the Euro will be used only for commercial and wholesale purposes. Actual Euro currency and coins will not be introduced until the end of the three-year period. Thus, Europeans will still carry their traditional national currencies in their wallets during the initial transition period.

.123 Once EMU occurs on January 1, 1999, an intermediate step will be introduced to currency conversions. For example, to convert dollars to French francs, the dollars will first need to be converted to Eurasia, using normal currency exchange rates. Then, the Eurasia need to be converted to French francs, using officially published conversion rates. This process is known as triangulation.

.124 After the initial three-year period, Euro currency will be released, the Euro will become the only legal tender of the participating member countries of the EU, and those countries' traditional currencies will be valueless.

### *Reasons for EMU*

.125 European countries are joining economically and monetarily for the following primary reasons:

- EMU will change fundamentally the way business is conducted in Europe by consolidating capital markets, further enhancing efficiencies in the European common market, and facilitating freer movement of goods, services, labor, and capital across national boundaries.
- EMU, if ultimately successful, promises to give the Euroland countries powerful financial and political clout. The Euro will be the sole currency of a large economic bloc of nations that will attempt to rival and more successfully compete with the economic and financial power of the United States.
- Related to the second point, EMU will offer the Euro as an alternative reserve currency to the U.S. dollar. Currently, the U.S. dollar is the preeminent currency in the world, used in most international transactions and forming the bulk of many countries' currency reserves. That fact bestows upon the U.S. tremendous financial and political power to wield on the world stage. The EU hopes that the Euro will substantially erode the strong position of the U.S. dollar and gain acceptance as a viable and sought-after currency reserve.

### *EMU's Effect on U.S. Businesses and U.S. Financial Institutions*

.126 U.S. businesses that trade with European customers or suppliers or have European operations will be faced with assorted challenges due to EMU. The immediate concern is the preparation of a company's financial systems to handle the Euro. Many companies, preoccupied with Year 2000 Issues, have not properly addressed Euro-system issues. The three-year phase in period further complicates the system problems, because businesses will be dealing in Eurasia through the banking system and dealing in traditional European currencies with customers. Thus, financial systems need to be able to handle the multiple conversions.

.127 The advent of the Euro will require that organizations reassess their operations in Euroland, including the geographic locations of operations, the products offered, and product-delivery methods. Management will need to understand how their investments and derivatives denominated in traditional European currencies will be converted to Eurasia and what effect EMU will have on their investment and business strategies and investment earnings. Also, entities will spend significant sums of money on EMU-related matters, including renovating systems, updating contracts, and modifying their product lines.

.128 On June 12, 1998, the Fed issued a letter (SR 98-16) that provides an overview of EMU and its impact on banking organizations. The letter addresses information technology implications, contractual and market issues, communication requirements, and payment system developments. Financial institutions that use foreign markets, or engage in commercial dealings with Euroland nations, will be substantially affected by EMU. Readers should read the Fed letter for a thorough review of EMU's impact.

.129 Finally, some financial institutions may suffer heavy losses in business areas, such as foreign exchange and international payments.

### ***Auditing Issues***

.130 Auditors working with institutions that will be affected by EMU will want to make inquiries about how the institution is preparing for EMU. Failure to prepare adequately for EMU could result in difficulties in transacting on clearing and settlement systems and in financial statement misstatements due to problems with accounting and other information systems that have not been appropriately renovated. In addition, auditors may need to consider accounting issues related to foreign currency translations and transactions, whether costs related to preparing for EMU have been properly accounted for, and the need for possible disclosures. Since EMU is not effective until January 1, 1999, some of these matters may not apply to December 31, 1998, financial statements. However, management letter comments on the institution's readiness for EMU could be helpful in making management aware of the importance of this issue.

.131 For auditors of institutions issuing calendar year-end financial statements, the effect of EMU will likely represent a Type II subsequent event, as discussed in AU section 560 of the AICPA *Professional Standards*.

.132 FASB EITF Topic D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union (EMU)*, discusses upgrade costs for projects to adapt information systems software for the Euro, and the preparation of comparative financial statements if there has been a change in reporting currency to the Euro. In addition, the SEC's Divisions of Corporation Finance, Market Regulation, and Investment Management issued Staff Legal Bulletin No. 6, which provides guidance on Euro-conversion-related issues such as the disclosure requirements that could arise.

#### **Executive Summary—European Economic and Monetary Union**

- A majority of the nations in the European Union (EU) have entered economic and monetary union (EMU) and have adopted the Euro as their currency.
- After an initial three-year phase in period, beginning on January 1, 1999, the Euro currency will become the only legal tender in the participating member countries of the EU.
- Financial institutions and other companies may need to prepare their financial systems to handle the Euro. Additionally, U.S. entities may need to reassess their operations in Euroland, and determine what effect EMU will have on their business and investment strategies.
- Auditors working with institutions that will be affected by EMU will want to make inquiries about how the institution is preparing for EMU. For auditors of institutions issuing calendar year-end financial statements, the effect of EMU will likely represent a type II subsequent event.
- The FASB has issued EITF Topic D-71 dealing with EMU.

### **Big Commercial Banks Dealing in Securities Underwriting**

*What should a CPA know about banks getting involved in securities underwriting?*

.133 Large banking companies are increasing their securities underwriting activities. As discussed in the Fundamental Changes in the Financial Services World section in this Alert, top-tier commercial banks have

been merging with investment banks and brokerages at a rapid pace. In fact, almost every bank holding company in the top twenty-five owns a securities subsidiary. These subsidiaries engage in capital markets activities such as underwriting state and local government revenue bonds, equities, commercial paper, corporate bonds, and mortgage-backed securities. Regulators have, over the past decade, eased restrictions on a commercial bank's ability to engage in capital markets activities, believing that banks must be allowed to engage in new businesses.

.134 Management of commercial banks have wanted to enter the lucrative securities underwriting business for decades. They realize that corporate customers often avoid costly traditional lending, in favor of raising money in the capital markets. Bank management can add significant revenue and profits to their operations by underwriting debt and equity securities. Moreover, management of commercial banks can enhance their investment client base and provide one-stop shopping to their corporate customers for all their financial services needs.

.135 Commercial banks will confront a clash of cultures when they combine with a brokerage or investment bank. They will have to absorb brokers who are more risk tolerant and more highly compensated than those who work at the bank. In combining the organizations, bank management will need to create an environment in which brokers can ply their trade in an effective and profitable manner. They will also need to structure carefully the new organization, assigning clear lines of authority to achieve a successful merger.

### ***Auditing Issues***

.136 Auditors should read the Effects of Adding and Expanding Product Lines, Services, and Businesses part of the Auditing Issues section under Fundamental Changes in the Financial Services World in this Alert for a description of auditing issues. Clearly, if the client is newly engaged in securities operations, the auditing team must possess adequate expertise in the securities industry to properly perform the audit.

## **Financial Institutions Offering Brokerage Accounts to Customers**

*Why are financial institutions offering brokerage accounts to customers, and what concerns exist?*

.137 More and more, financial institutions are offering asset-management accounts to their retail customers. These accounts combine a bank account with a brokerage account and contain a sweep feature, where idle cash sitting in the account is swept into an investment such as a money-market mutual fund.

### ***Benefits of Providing Asset-Management Accounts***

.138 Management of financial entities hope to gain customers and their investment dollars by offering asset-management accounts. They are trying to gain and retain customers who are investment-savvy and seek investment vehicles for their money beyond traditional bank products. Management of these institutions, including smaller community institutions, are looking for ways to increase earnings and expand the range of financial services they offer the public. Providing asset-management accounts helps financial institutions achieve those goals.

### ***Management and Regulator Concerns***

.139 The asset-management accounts offered by some financial institutions are sometimes more expensive and offer fewer investment options than the accounts offered by competitors in the brokerage industry. Additionally, these accounts can depress profit margins, because they pay higher interest rates than normal checking accounts and they lower deposit levels by sweeping excess cash into investments.

.140 A customer who invests his money in an institution's asset management account may mistakenly believe that his money is insured by the Federal Deposit Insurance Corporation (FDIC). That customer could

suffer significant losses if the institution fails and the money sitting in the asset-management account is uninsured. A statement issued by the four federal banking agencies provides instructions to institutions offering nondeposit investment products to retail customers. This statement is titled FIL 9-94 and can be obtained at the Web sites of the banking agencies. See "Information Sources" at the end of this Alert for Web site addresses.

**.141** In the statement, the banking agencies state that sales activities for nondeposit investment products should ensure that customers for these products are clearly and fully informed of the nature and risk associated with these products. Customers should be told that such products are not FDIC insured. An entity involved in selling these investment products should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the entity's program and addressing, at a minimum, the concerns described in the interagency statement. These are just some of the points made in the statement. Readers should read the statement to fully understand its requirements.

### ***Auditing Issues***

**.142** Auditors should read the Effects of Adding and Expanding Product Lines, Services, and Businesses part of the Auditing Issues section under Fundamental Changes in the Financial Services World in this Alert for a description of auditing issues that may apply to a situation in which a client has begun offering asset-management accounts to their customers. In addition, institutions may incur high acquisition costs when adding these accounts to their product mix. Auditors of those institutions may need to focus on the recoverability of those costs and the appropriateness of the related accounting. Finally, auditors may need to determine that their client complies with the interagency statement discussed above.

## **Financial Institutions Continue Their Advance Into the Insurance Industry**

### ***What are the issues connected to the ongoing movement of financial institutions into the insurance business?***

**.143** In a search for higher earnings and fee-generated income, management of financial entities continue to expand their insurance operations. Management has been helped by recent favorable court decisions and regulatory rulings that have paved the way for further penetration of the insurance industry by financial institutions. For instance, a recent OCC ruling allows banks to sell insurance from urban areas, not just small towns. Also helping management is the changing attitudes of the insurance industry, which has become more agreeable to the entrance of financial organizations.

**.144** Financial institutions engage in insurance activities in various ways. Currently, most institutions are not allowed to own insurance companies. Instead, institutions form alliances with insurers, set up direct marketing programs with them, and sometimes acquire insurance agencies. Insurers underwrite and service the insurance product, and the financial institution handles the other aspects of the business, such as marketing. The institution sells insurance by referring its customers to the insurance representative, by direct mail and by other methods.

### ***Challenges to Management***

**.145** Management's insurance activities may not always succeed. They may have difficulty integrating the insurance business with their core businesses. Management may have to resolve the cultural differences that exist between insurance representatives and banking employees. Often, account managers at financial institutions are reluctant to let others interact with their customers. Thus, there may be tension between the insurance representative and the account or relationship manager. Furthermore, insurance activities generally require a high volume of sales to be profitable. Management at larger institutions will therefore find it easier to succeed.

### ***Auditing Issues***

.146 Auditors should read the Effects of Adding and Expanding Product Lines, Services, and Businesses part of the Auditing Issues section under Fundamental Changes in the Financial Services World in this Alert for a description of auditing issues that may apply to a situation in which a client has begun engaging in insurance activities. Insofar as insurance activities can be complicated, auditors may need to ensure that their engagement team possesses the necessary insurance expertise or specialists to properly conduct the audit.

.147 Auditors of institutions engaged in insurance activities should consider whether management has appropriately accounted for transactions related to those activities. Review the AICPA Audit and Accounting Guides *Property and Liability Insurance Companies* and *Stock Life Insurance Companies* for a description of applicable guidance.

### **Auto and Equipment Leasing**

*Why are institutions engaging in the business of leasing cars and equipment to customers, and what should a CPA be aware of in working with such activities?*

.148 Numerous financial institutions, especially community banks and credit unions, are entering the business of consumer vehicle leasing and equipment leasing. This trend is part of the overall convergence taking place in the financial services industry. Institutions are looking at related business areas to increase revenue and profits. The popularity of leasing over ownership is increasing with consumers. Financial institutions recognize that if they fail to finance their customers' automobiles and equipment through leasing arrangements, those customers will go elsewhere.

.149 Of course, finance companies have been involved in leasing operations for many years. However, to many other institutions, leasing is a new business. Understanding the complicated accounting for leasing activities can be risky for newcomers.

.150 FASB Statement No. 13, *Accounting for Leases* (FASB, *Current Text*, vol. 1, sec. L10), and its related interpretations and amendments provide authoritative guidance on accounting for leases. Operating leases generally run for periods considerably shorter than the useful lives of related assets. At the expiration of such leases, the assets generally are sold or leased again. Direct financing leases are similar to other forms of installment lending in that lessors generally do not retain benefits and risks incidental to ownership of the property subject to leases. Such arrangements are essentially financing transactions that permit lessees to acquire and use property.

.151 Auditors should read the Effects of Adding and Expanding Product Lines, Services, and Businesses part of the Auditing Issues section under Fundamental Changes in the Financial Services World in this Alert for a description of auditing issues that may apply to a situation in which a client has begun engaging in leasing activities. Insofar as leasing activities can be complicated, auditors may need to ensure that their engagement team possesses the necessary expertise or specialists to properly conduct the audit.

### **Dwindling Deposits**

*Are dwindling deposit levels a concern?*

.152 Core deposits, such as checking accounts and certificates of deposit (CDs), have been declining significantly or have experienced limited growth at many financial institutions, especially smaller community institutions. At the same time, loan demand at most of these institutions has been increasing at a higher pace. Deposits are vital to institutions because they are a primary wellspring of money used to generate revenue. The main reason for this deposit decline is customers' growing preference to place their money in

high-earning mutual funds and stocks. Financial institutions cannot compete for those deposit dollars by offering their low-rate CDs and other time deposits. Many younger customers have never lived through a long period of decline in the stock markets. They see financial institutions as places to process their paychecks and maintain a little cash liquidity.

.153 Management of many institutions are therefore involved in a liquidity struggle. They cannot use their normal deposit base to meet growing loan demand and withdrawals. So they must seek alternate sources of ready money. These sources include borrowing cash from the Federal Home Loan Bank (FHLB) or other institutions (Fed funds), selling assets, or increasing interest rates. Smaller institutions are harder pressed to find alternate sources of funds, since they cannot avail themselves of the capital markets like larger entities do. Using alternate sources of cash decreases profit margins inasmuch as borrowed money is generally more costly than deposit sources with low rates. Management of financial institutions should carefully manage their sources of liquidity and be ready and able to respond to market conditions that affect their funding sources.

### ***Auditing Issues***

.154 Auditors of institutions facing serious declines in deposits should carefully assess the liquidity risk of their clients. An institution may default on its obligations, if a liquidity deficiency becomes severe. Also, failure to gain additional funding sources may depress earnings growth. Auditors should assess whether an institution possesses the necessary liquidity to continue as a going concern. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to the auditor in conducting an audit in accordance with GAAS with respect to evaluating whether there is substantial doubt about an entity's ability to continue as a going concern.

.155 If management plans to sell assets to procure additional funding, auditors should conclude whether those assets are properly classified and valued. In addition, if management borrows funds, auditors need to perform auditing procedures applicable to debt balances (see chapter 13 of the *Audit and Accounting Guide Banks and Savings Institutions* for guidance).

### **Refinancing Rage, Prepayment Risk, and Accounting Issues Related to the Sale or Securitization of Financial Assets**

*How does the current wave of refinancings affect financial institutions and audit risk?*

.156 People are refinancing their mortgages and other home equity loans at a remarkable rate due to the low interest rate environment. By refinancing their loans, these people are generating extraordinary loan volume for mortgage bankers and home equity lenders. At the same time, refinancings also generate some problems and risks.

### ***Accounting***

.157 Institutions that record gains on sales of loans, in accordance with FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Current Text*, vol. 1, sec. F38), may record sizeable write-downs of servicing assets or other retained interests during periods of heavy refinancings. This has occurred to a number of subprime mortgage lenders recently. Many institutions securitize and sell their loans to institutional investors. Upon selling the loans, lenders estimate a fair value of retained interests and record a gain on the sale. (Note that FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), requires creditors to disclose assumptions used to value new or retained interests in a securitization.) Lenders are required to estimate delinquencies and prepayments when recording the residual interest and sale of assets. A serious risk lies in not estimating appropriate prepayment rates when calculating the gain booked to income. When the massive refinancing wave hits, institutions that failed to adequately anticipate the refinancing prepayments must write down the residuals and record a loss. These losses can be significant.

### ***Servicers Take a Hit***

.158 Mortgage loan servicers will see their businesses diminish as their servicing portfolios are prepaid and taken off the books. Some of these servicers lack large enough loan origination networks to generate new loan volume and thus will suffer more serious financial difficulties.

### ***Auditing Issues***

.159 During a period of intense refinancings, auditors should evaluate carefully the assumptions used in valuing residual interests in sold loans. These assumptions may be overly optimistic. A determination should be made about the reasonableness of the gains recorded in the financial statements. In these circumstances, auditors should consider SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. Auditors should also analyze prepayment data used by management to calculate servicing rights at sale date and the systems used to update prepayment data over time for actual prepayment experience.

.160 The SEC staff is becoming increasingly concerned over the application of GAAP to a sale or securitization of financial assets, and assets that are retained or received, or liabilities that are incurred. Management and auditors should be aware of EITF Topic D-69 *Gain Recognition on Transfers of Financial Assets under FASB Statement No. 125*, which reminds financial statement preparers of the requirements for recognition, measurement, and disclosure.

.161 When an entity securitizes a loan or receivable it is often required to place the initial residual cash flows from the paydown of the trust in an over collateralization account to enhance the credit rating on the senior tranches of the trust. Such cash will then remain in the trust as collateral until certain performance targets (for example, delinquencies or losses) are met. Once such targets are met and sustained, cash is released to the transferor.

.162 There are currently two methods used to present value these cash flows. The first method (cash in) assumes that the residual cash placed in the over collateralization account are available to the entity when placed in this account. In contrast, the second method (cash out) assumes that the cash flows placed in an over collateralization account are not considered income until such cash flows are actually received by the entity.

.163 The SEC staff believes that the cash out is the appropriate method to use in valuing this interest only residual.

.164 Auditors may want to consider the effects of declining business and portfolios at servicers that are being adversely affected by the voluminous refinancings occurring in the industry. A servicer's operations, earnings, and profits may suffer substantial decline. Also, a servicer's management will probably experience intense pressure under these circumstances. See, therefore, the "Auditing Issues" part of the "Management Under Pressure and Possible Audit Risk" section in this Alert for possible other issues.

.165 In addition, auditors may need to consider how management is managing the risks inherent in their servicing portfolios, if such portfolios are not hedged.

.166 Finally, auditors should be familiar with the guidance in FASB Statement No. 125 and assess management's application of its requirements. Auditors should read chapter 8 of the Audit and Accounting Guide *Banks and Savings Institutions*, chapter 7 of the Audit and Accounting Guide *Audits of Credit Unions*, and chapter 2 of the Audit and Accounting Guide *Audits of Finance Companies*, as applicable, for a more thorough discussion of accounting and auditing matters related to this topic.



## Internal Audit Outsourcing

### *Are there concerns over the outsourcing of internal audit activities?*

.167 In addressing various quality and resource issues, many institutions have been engaging independent public accounting firms to perform work that has been traditionally done by internal auditors. These arrangements are called internal audit outsourcing. The federal banking agencies are concerned that the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the institution's safety and soundness. Furthermore, the agencies want to ensure that these arrangements with outsourcing accounting firms do not leave management and directors with the impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

### *Policy Statement Issued*

.168 As a result of their concerns, on December 22, 1997, the four federal banking agencies issued an interagency policy statement on the internal audit function of insured depository institutions, bank holding companies, and the U.S. operations of foreign banking organizations. The Fed, FDIC, OCC, and the Office of Thrift Supervision (OTS) issued the policy to provide guidance and sound practices to help financial institutions effectively manage their internal audit function, whether performed by an institution's own employees or by outside experts under an outsourcing arrangement. The policy statement sets forth some characteristics of sound practices for the internal audit function and the use of outsourcing accounting firms for audit activities. Additionally, the policy statement discusses the effect that outsourcing arrangements may have on the independence of an external auditor who is also providing external audit services to an institution.

.169 A client may have outsourced some of its internal audit function to the auditor's firm. Even though the auditor may be providing internal audit services, the board of directors and senior management of an institution are still responsible for ensuring that the system of internal control (including the internal audit function) operates effectively. The outsourcing arrangement should not increase the risk that a breakdown of internal control can occur. A written contract or engagement letter should clearly set forth the internal audit duties of the institution and the duties of the auditor's firm. It is preferable that the letter indicates that the auditor may not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of an employee (see Independence Issues as follows).

### *Independence Issues*

.170 Questions have been raised about whether external auditors who perform an audit of the institution's financial statements or provide any other service that requires independence can also perform internal audit services and still be considered independent. The AICPA has issued guidance to CPAs on independence that addresses these issues. Interpretation No. 101-13 of the AICPA *Code of Professional Conduct* states that the CPA's performance of services, required by the outsourcing arrangement, would not be considered to impair independence with respect to an institution for which the CPA also performs a service requiring independence, provided the CPA, or the CPA's firm, does not act or appear to act in a capacity equivalent to a member of the institution's management or as an employee.

.171 Interpretation No. 101-13 lists activities that would impair a CPA's independence, if the CPA performs those activities as part of internal audit services. Some of those activities are—

- Performing ongoing monitoring activities or control activities that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the institution's operating processes that are equivalent to those of an ongoing compliance or quality control function. An example is reviewing loan originations as part of the institution's approval process.

- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function.
- Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the institution.

Interpretation No. 101-13 contains a complete listing of activities that would impair independence.

.172 The federal banking agencies are concerned that outsourcing arrangements may involve activities that compromise, in fact or appearance, the independence of the external auditor. The agencies believe that other actions compromise independence in addition to those in Interpretation 101-13. Such actions include—

1. Contributing in a decision-making capacity or otherwise actively participating (for example, advocating positions or actions rather than merely advising) in committees, task forces, and meetings that determine the institution's strategic direction
2. Contributing in a decision-making capacity to the design, implementation, and evaluation of new products, services, internal controls or software that are significant to the institution's business activities.

### ***Further Information***

.173 Auditors should read the interagency policy statement and the AICPA's Interpretation No. 101-13 for a full understanding of this issue. The policy statement is available on the FDIC Web site, at [www.fdic.gov/banknews/fils/1997/fil97133.html](http://www.fdic.gov/banknews/fils/1997/fil97133.html), or by calling the Federal Reserve Freedom of Information Office at 202-452-3684. Interpretation No. 101-13 can be found in the AICPA's *Code of Professional Conduct* (call 1-888-777-7077 for ordering information).

#### **Executive Summary—Internal Audit Outsourcing**

- Many institutions have been engaging independent public accounting firms to perform work that has been traditionally done by internal auditors. The federal banking agencies are concerned that these internal audit outsourcing arrangements may not contribute to the institution's safety and soundness.
- Auditors should become familiar with the AICPA Interpretation 101-13, "Extended Audit Services," of the Rules of Conduct and a related interagency statement issued by banking regulators to gain a better knowledge of what is acceptable when it comes to internal audit outsourcing.

### **Repurchase and Reverse Repurchase Agreements**

*What does one need to be concerned with regarding repurchase agreements?*

#### ***Risks***

.174 Depository institutions and others involved with repurchase and reverse repurchase agreements have sometimes incurred significant losses as a result of a default or fraud by the counter-party to the transaction. Inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions are the most important factors causing these heavy losses.

.175 Repurchase and reverse repurchase agreements can be a useful asset and liability management tool, but these agreements can expose a depository institution to serious risks if they are not managed appropriately. It is possible to reduce repurchase and reverse repurchase agreement risk if the depository institution executes written agreements with all counterparties and custodian banks. Compliance with these written agreements should be monitored on a daily basis.

### ***Revised FFIEC Policy Statement***

.176 The FFIEC recently revised its supervisory policy statement on repurchase and reverse repurchase agreements. It provides guidance to financial institutions on those agreements, including guidelines for written repurchase agreements, policies and procedures, credit risk management, and collateral management. The FFIEC policy statement has three principal revisions. First, a new section covering the requirements of the Government Securities Act has replaced an obsolete section dealing with unregulated securities dealers. Second, the policy statement has been streamlined and updated to generally cover other laws and regulations. Third, the list of written repurchase agreement provisions has been updated to reflect current market practice. For more information on the revised policy statement, call the FDIC's Division of Supervision at (202) 898-3618. The revised policy statement can be obtained at the FFIEC's Web site, at [www.ffiec.gov](http://www.ffiec.gov).

### ***Auditing Issues***

.177 Auditors should read chapter 12 of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* and chapter 4 of the Audit and Accounting Guide *Audits of Credit Unions*, as applicable, for a thorough discussion of repurchase and reverse repurchase agreements. Those chapters suggest possible auditing steps, including—

- Auditors may want to review the latest audited financial statements of the counterparties to the institution's repurchase and reverse repurchase agreements. They may also want to review other available reports, such as reports on internal control or special-purpose reports by the dealer's accountant, to determine whether the dealer has net capital in excess of statutory requirements. If there is reason to question the creditworthiness of the counterparty, the auditor should consider consulting with legal counsel regarding whether, in the event of the counterparty's inability to return (sell back) the collateral securities, the institution has the right to set off the loan liability against the collateral.
- Whenever a buyer-lender or its agent does not take delivery of the securities, the auditor should consider confirming not only the occurrence and terms of the transaction and the obligation to repurchase the securities but also that they have not been delivered and are being held on the institution's behalf. The auditor should also recognize that, when delivery is not made, the transaction has many of the attributes of an unsecured loan. Accordingly, the auditor should consider assessing the reputation and financial strength of the seller-borrower and of the custodian.

### ***Loan Participations***

*Given the upswing in loan participations, what should a CPA remember about such transactions?*

.178 Loan participation arrangements have been on the upswing in the credit union industry. As such, auditors are reminded of the following matters:

- Entities that participate in a loan should clearly delineate the responsibilities of each participant, such as who has servicing responsibility.
- The purchaser of a loan participation is responsible for conducting a credit analysis. Loan files for purchased participations should be available at the institution and should contain pertinent documents, or copies of them.
- The auditor generally will want to obtain copies of any reports issued under SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), by the servicer's independent accountants when planning the extent of test work necessary in the loan area.
- The auditor should be familiar with the requirements of paragraphs 5.18–5.21, 5.70, and 5.71 of the AICPA Audit and Accounting Guide *Audits of Credit Unions* (with conforming changes as of May 1, 1998), and

with the requirements of paragraphs 6.38, 6.39, and 6.112 of the AICPA Audit and Accounting Guide *Banks and Savings Institutions* (with conforming changes as of May 1, 1998), as applicable.

## Money Laundering<sup>1</sup>

*What precisely is money laundering all about, and what are a CPA's responsibilities?*

.179 The Treasury Department has recently intensified its review of anti-money laundering measures at financial institutions. Keeping in step with the Treasury Department, auditors should refresh their understanding of money laundering and its implications.

.180 Criminals use financial institutions to launder the proceeds of crime. The evolving dynamics in the depository institutions and lending industry generate great business opportunities for financial institutions, but they also generate risks for institutions, including increased money laundering vulnerability. Banks are the most vulnerable of financial institutions, because they provide the broadest range of financial services that money launderers want and need.

### *Definition of Money Laundering*

.181 Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from \$300 billion to \$1 trillion.

.182 While money laundering activity and methods become increasingly complex and ingenious, its "operations" tend to consist of three basic stages or processes: placement, layering, and integration.

.183 *Placement* is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner as to avoid detection by bank and nonbank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends, and law-enforcement strategies and techniques, to keep their proceeds concealed, their methods secret, and their professional resources anonymous. The most common placement techniques include structuring<sup>2</sup> cash deposits into legitimate bank and other financial institution accounts and converting cash into other monetary instruments.

.184 *Layering* is the process of generating a series or layers of transactions to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include outbound electronic funds transfer, usually directly or subsequently into a "bank secrecy haven" or a jurisdiction with more liberal recordkeeping and reporting requirements; withdrawals of already-placed deposits in the form of highly liquid monetary instruments, such as money orders and travelers checks; and internal transfers between accounts, increasing the likelihood of hold removal and nominee accounts controlled by an inside perpetrator.

.185 *Integration*, the final money-laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions.

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<sup>1</sup> The Treasury Department has had significant input in drafting the content of this section of the Alert. As such, it provides auditors of financial institutions with a unique insight into how federal regulators view this important area of concern.

<sup>2</sup> Structuring means breaking up large amounts of currency into smaller amounts to conduct transactions in such a manner as to avoid suspicion and detection.

.186 The world's largest and wealthiest economies tend to serve as the primary hosts for money launderers and their operations. These economies tend to harbor the greatest demand for illegal drugs, still the primary predicate money-laundering activity. Also, sophisticated money launderers need similarly sophisticated financial services sectors to successfully launder—to place, layer, and integrate proceeds.

### ***Related Laws and Regulations***

.187 The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the Treasury Department to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money-laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties.

.188 The BSA contains a suspicious activity reporting (SAR) requirement. All financial institutions operating in the U.S. are required to report suspicious activity following the discovery of: insider abuse involving any amount, violations aggregating \$5,000 or more when a suspect can be identified, violations aggregating \$25,000 or more regardless of a potential suspect, or transactions aggregating \$5,000 or more that involve potential money laundering or violations of the BSA.

.189 The BSA also contains regulations requiring financial institutions to file currency transaction reports (CTRs) for cash transactions greater than \$10,000. A new rule on CTR exemptions took effect on January 1, 1998 (see the FDIC's Financial Institution Letter 10-98 for details about the exemptions).

### ***Money Laundering and Financial Statements***

.190 Money laundering usually results in large quantities of illicit proceeds that need to be distanced from their source as quickly as possible in an undetected manner. Consequently, it is less likely that money laundering will be detected in financial statement audits than other types of illegal activities. In addition, the activity is more likely to cause assets to be overstated rather than understated, with shorter-term fluctuations in account balances rather than cumulative changes. Thus, money laundering is considered to be an illegal act with an *indirect* effect on financial statement amounts under SAS No. 54, *Illegal Acts by Clients*, (AICPA, *Professional Standards*, vol. 1, AU sec. 317). Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

.191 Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

#### **Executive Summary—Money Laundering**

- The Treasury Department has recently intensified its review of anti-money laundering measures at financial institutions. Auditors should have an awareness of what money laundering is and should understand their responsibilities regarding money laundering.
- Money laundering is a global activity in which cash or other funds from illegal activities are funneled through legitimate businesses to conceal the initial source of funds.
- Money laundering usually results in large amounts of illicit proceeds that need to be distanced from their source as quickly as possible, and it is less likely to be detected in a financial statement audit than other types of illegal activities.
- Under SAS No. 54, money laundering is considered to be an illegal act with an indirect effect on financial statement amounts. The auditor does not have a detection responsibility for such illegal acts. However, auditors should be aware of the possibility that such illegal acts have occurred.

## New Sanctions

*With what countries and entities are financial institutions prohibited from doing business?*

.192 The Department of the Treasury's Office of Foreign Assets Control (OFAC) announced on June 10, 1998, that new sanctions have been imposed against the governments of Serbia, Montenegro, and the Federal Republic of Yugoslavia (Serbia and Montenegro) (FRY S&M). All property in which these governments have an interest is blocked immediately and financial transactions involving them are prohibited, except for transactions within the FRY S&M conducted exclusively through its domestic banking system in dinars or using bank notes or barter. OFAC also administers sanction programs against Libya, Iraq, Cuba, the National Union for the Total Independence of Angola (UNITA), North Korea, Syria, Sudan, Bosnian-Serb-controlled areas of the Republic of Bosnia and Herzegovina, international terrorists, and international narcotics traffickers.

.193 OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals. Information concerning OFAC rules, lists of prohibited entities, and general OFAC information can be obtained on the Web at [www.ustreas.gov/treasury/services/fac/fac.html](http://www.ustreas.gov/treasury/services/fac/fac.html).

## Regulatory Matters

*What significant regulatory developments have occurred?*

### New Independence Standards Board

.194 In an anticipated move, the SEC has given authority to the Independence Standards Board (ISB) to develop independence standards for public companies and provide guidance on specific auditor independence issues.

.195 According to Financial Reporting Release (FRR) No. 50, issued on February 18, 1998, the SEC will allow the ISB to provide auditor independence principles, standards, interpretations, and practices, which means the commission no longer will promulgate separate independence rules. However, the SEC has not abdicated its own statutory responsibilities, it will provide oversight of the ISB and will take enforcement action when appropriate. According to the reporting release, the SEC's relationship with the ISB will be similar to the one it currently has with the FASB.

.196 The ISB has an independence issues committee made up of nine representatives from the AICPA SEC practice section and a full-time staff located in the AICPA's New York City offices. All SEC practice section member firms should now contact the ISB staff rather than the SEC staff for guidance on auditor independence issues related to SEC registrants.

.197 The following are unchanged:

- Auditors of private companies will comply with the AICPA Professional Ethics Executive Committee's independence rules.
- The state boards of accountancy and the AICPA ethics committee will undertake their own disciplinary actions regarding auditor independence.

### Credit Union Investment and Deposit Activities

.198 In 1997, the National Credit Union Administration (NCUA) issued a final rule on Investment and Deposit Activities (Part 703) of credit unions that clarifies a number of areas, adds restrictions on some securities, broadens authority in certain areas, and attempts to ensure that both credit unions' management and board of directors can authorize only the purchase of investments they understand. Subsequently, the

NCUA adopted certain amendments to the ruling that revise the broker-dealer and safekeeping provisions. Auditors should read the new amendments, as deemed necessary. The ruling and amendments on credit union investment and deposit activities can be obtained from the NCUA Web site, at [www.ncua.gov](http://www.ncua.gov), or by calling the NCUA at (703)-518-6360.

### External Audits for Small Banks and Thrifts

**.199** The Fed, FDIC, OCC, and the OTS, under the auspices of the FFIEC, published in the *Federal Register* on Feb. 17, 1998, a proposed policy statement on external audit programs for banks and thrifts. The proposal is available on the FDIC Web site, at [www.fdic.gov/banknews/fils/1998/fil9816.html](http://www.fdic.gov/banknews/fils/1998/fil9816.html).

**.200** Banks and savings institutions with assets of \$500 million or more are already required to have annual audits under section 36 of the Federal Deposit Improvement Act. Therefore, the FFIEC proposal applies only to banks and thrifts under the asset threshold that are not otherwise subject to audit requirements. The FFIEC encourages each institution, as part of its external audit program, to obtain an annual audit of its financial statements by an independent public accountant. If an institution's board of directors or audit committee determines that an audit is not appropriate, two other acceptable alternatives are described: a report on the institution's balance sheet or an attestation report on internal controls over specified schedules of its regulatory reports, including those relating to loans and securities. Both engagements should be performed by an independent public accountant.

**.201** The FFIEC also encourages banks and thrifts to establish an audit committee consisting entirely of outside directors, if practicable.

### Directors Exam Policy Rescinded

**.202** The FDIC has rescinded its outdated Policy Statement Providing Guidance on External Auditing Procedures for State Nonmember Banks, effective December 31, 1997. The Policy Statement recommended, as an alternative to an audit for banks not subject to the audit requirement in section 36 of the Federal Deposit Improvement Act, that the board of directors or audit committee consider having certain specified auditing procedures performed by an independent public accountant as its external auditing program. However, the FDIC has now determined that the specific procedures recommended in the Policy Statement no longer are an acceptable alternative to a financial statement audit nor are they the best method for meeting the FDIC's supervisory objectives with respect to external auditing work. Furthermore, under the requirements of the Statement on Standards for Attestation Engagements (SSAE) No. 4, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 600), these specific procedures are unworkable. Accordingly, the FDIC has withdrawn this Policy Statement.

**.203** Auditors are reminded that for state-mandated directors examinations and other agreed-upon procedures engagements performed, the requirements of SSAE No. 4 and SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), must be met. As required by AT sec. 600.11 and AU sec. 622.10, if the practitioner cannot obtain agreement from a party (such as the state bank regulator or 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.

### Bank Independent Audit and Reporting Requirements Revised

**.204** The FDIC has amended the Annual Independent Audit and Reporting Requirements (Part 363) to implement the provision of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 that

repealed section 36(e) of the Federal Deposit Insurance Act (*Federal Register*, November 28, 1997). Section 36(e) had required each insured depository institution with \$500 million or more in total assets to have an independent public accountant perform specific procedures for determining compliance with designated safety and soundness laws. To conform Part 363 to the revised statute, the amendment eliminates from the regulation Schedule A to appendix A, "Agreed Upon Procedures for Determining Compliance with Designated Laws." Bank management is still required to file with the FDIC and appropriate federal and state banking agencies an annual report that includes a statement of its responsibilities for complying with designated laws and an assessment of the bank's compliance with such laws and regulations. The amendment also updates certain references to other documents, eliminates an unnecessary filing by independent public accountants, and aligns the filing requirements with the FDIC's current approach for supervising banking organizations.

## Investment Securities and End-User Derivatives Activities

.205 The Fed, FDIC, OCC, OTS, and the NCUA (the agencies), under the auspices of the FFIEC have issued a Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities. The Statement rescinds the Supervisory Policy Statement on Securities Activities, published in 1992. Many elements of that prior Statement are retained in the 1998 Statement, whereas other elements have been revised or eliminated.

.206 The 1998 Statement provides guidance to financial institutions on sound practices for managing the risks of investment securities and end-user derivatives activities. In adopting the 1998 Statement, the agencies are removing the specific constraints in the 1992 Statement concerning investments by insured depository institutions in high-risk mortgage derivative products. The agencies believe that it is sound practice for institutions to understand the risks related to all their investment holdings. Accordingly, the 1998 Statement substitutes broader guidance than the specific pass/fail requirements contained in the 1992 Statement. Other than for the supervisory guidance contained in the 1992 Statement, the 1998 Statement does not supersede any other requirements of the respective agencies' statutory rules, regulations, policies, or supervisory guidance. Each agency has issued or will issue separate, additional guidance on this issue, including guidance on reporting of securities activities.

.207 The guidance in the 1998 Statement applies to all securities in held-to-maturity and available-for-sale accounts as defined in FASB Statement No. 115, *Investments in Debt and Equity Securities* (FASB, *Current Text*, vol. 1, sec. I80), certificates of deposit held for investment purposes, and end-user derivative contracts not held in trading accounts. This guidance covers all securities used for investment purposes, including money market instruments, fixed-rate and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities, and mortgage-derivative products. Additionally, the 1998 Statement covers all end-user derivative instruments used for nontrading purposes, such as swaps, futures, and options. The 1998 Statement applies to all federally insured commercial banks, savings banks, savings associations, and federally chartered credit unions.

.208 Management and auditors should read the new Statement and understand its provisions, as deemed necessary based on the circumstances of the engagement. The Statement can be obtained on the FFIEC Web site, at [www.ffiec.gov](http://www.ffiec.gov), or by calling the individual agencies (see the "Information Sources" section at the end of this Alert for phone numbers).

## Credit Union Service Organizations

.209 The NCUA has updated, clarified, and streamlined existing rules concerning credit union service organizations (CUSOs), a common means of outside provision of services to federal credit unions (FCUs) and to credit union members. The final rule clarifies NCUA's authority to review CUSO books, records, and operations; adds corporate separateness requirements and additional permissible services; changes the legal opinion requirements; maintains safety and soundness criteria; and ensures the continuity and growth of



services to FCUs and their members conducted through CUSOs. Related conforming changes are also made to credit union service contract, fixed asset, and corporate credit union rules. Information is available at the NCUA Web site, at [www.ncua.gov](http://www.ncua.gov).

## **Market Risk**

.210 The FDIC, OCC, and the Fed have amended their respective risk-based capital requirements to reduce the regulatory burden for banks with significant trading activities. The market-risk rule applies to banks whose trading activity equals 10 percent or more of their total assets, or whose trading activity equals \$1 billion or more. The interim final rule amends the risk-based capital requirement of the market-risk rule to eliminate a requirement that an affected institution must hold capital for specific risk equal to at least 50 percent for what would be derived using a standardized calculation. The interim final rule became effective on December 31, 1997.

## **Treasury Department Studies Credit Unions**

.211 The Treasury Department completed its study of credit unions and NCUA's management of the Share Insurance Fund (NCUASIF) in December 1997. The report concluded that the credit union community was in overall good condition. It recommended that the NCUASIF remain under NCUA purview. The report called for no major changes in credit union supervision or regulation.

.212 The report recommended that Congress and NCUA make important safety and soundness rules readily accessible; increase the asset reserve target for federal credit unions from 6 percent to 7 percent; adopt a prompt corrective action system for federally insured credit unions, similar to FDIC's system; require that federally insured credit unions over \$500 million obtain independent financial audits by CPAs; and, develop risk-based net-worth requirements for large, complex credit unions.

.213 The report also made several recommendations specifically requiring congressional action, including establishment of a Share Insurance Fund available assets ratio of 1 percent of insured shares.

## **Bank Holding Company Tier 1 Leverage Capital Standard**

.214 The Fed has issued a final rule amending the Tier 1 leverage capital standard for bank holding companies. The amendment to Regulation Y establishes a minimum ratio of Tier 1 capital to total assets (leverage ratio) of 3 percent for bank holding companies that either are rated composite "1" under the BOPEC rating system or have implemented the Fed's risk-based capital market risk measure. The minimum leverage ratio for all other bank holding companies is 4 percent. Bank holding companies are expected to maintain higher-than-minimum capital ratios if they have supervisory, financial, operational, or managerial weaknesses, or if they are anticipating or experiencing significant growth. The rule is effective June 30, 1998.

## **Tax Court Decision Affects Loan Expense Deductions**

.215 On June 8, 1998, a Tax Court ruled that institutions should, for income-tax purposes, deduct loan expenses over the life of the loan and should not deduct the expenses immediately in the year the loan is originated. This will increase an institution's taxable income, since the loan expenses will be spread out over a number of years. This decision upholds a 1992 Internal Revenue Service (IRS) ruling that was not immediately enforced by the IRS. Loan expenses include costs that are incurred in extending loans to customers, such as the cost of obtaining property appraisals. A decision has not yet been made about whether this court ruling will be appealed. CPAs should monitor this issue for further developments.

## **International Rules Streamlined**

.216 The FDIC revised three groups of rules and regulations for international banking, consolidating them into one regulation, Part 347. The new regulation reduces filing requirements, allowing banks to com-

pete abroad more effectively. Most important for CPAs, Part 347 simplifies accounting for fees on international loans. Instead of requiring specific accounting procedures, the new regulation directs banks to follow GAAP. Not only does the new regulation ease filing burdens for banks that wish to open a foreign branch or make a foreign investment, but it also amends regulations governing insured branches of foreign banks and specifies deposit rules for uninsured state-licensed branches of foreign banks. New Part 347 is effective July 1, 1998. For more information, contact the FDIC Division of Supervision at (202) 898-3671.

## New Auditing and Attestation Pronouncements

### *What new auditing and attestation standards have been issued?*

.217 Presented below are descriptions of recently issued auditing and attestation pronouncements that may be applicable to financial institutions. For a complete list and description of all new auditing and attestation standards, auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. Call the AICPA Order Department at 1-888-777-7077 to order.

### New Auditing Standards

#### ***SAS No. 86, Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties***

.218 The Auditing Standards Board (ASB) issued SAS No. 86 in March 1998 to reflect the issuance of SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners that have examined or reviewed management's discussion and analysis (MD&A) in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special type of agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

#### ***SAS No. 87, Restricting the Use of an Auditor's Report***

.219 The ASB issued SAS No. 87 in September 1998 and it is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The SAS states that an auditor should restrict the use of a report when—

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with generally accepted accounting principles or other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used in restricted-use reports, and requires an auditor to restrict a combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

### **SAS No. 21, Segment Information—Rescinded**

.220 SAS No. 21, *Segment Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 435), contained guidance for auditing disclosures made in accordance with the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 was superseded upon the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30), which is effective for fiscal years beginning after December 15, 1997. Accordingly, the ASB has rescinded SAS No. 21 effective for audits of financial statements to which FASB Statement No. 131 has been applied. In its place, auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31 has been issued. See the "New Auditing Interpretations and AITF Advisory" section of the general *Audit Risk Alert—1998/99* [AAM section 8010] for a more detailed discussion of the new Interpretation.

### **New Attestation Standard**

#### **SSAE No. 8, Management's Discussion and Analysis**

.221 Issued by the ASB in March 1998, SSAE No. 8 provides guidance to a practitioner concerning the performance of a review or examination of MD&A prepared pursuant to the rules and regulations of the SEC. The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8—

1. Sets conditions for engagement performance for both examinations and reviews of MD&A.
2. Provides extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A.
3. Provides a comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8.

SSAE No. 8 became effective upon issuance.

.222 In September 1998, the ASB voted to issue the exposure draft *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity's Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation* as a final standard. See the "Exposure Draft Issued by the Auditing Standards Board" section of the general *Audit Risk Alert—1998/99* [AAM section 8010] for further information.

### **New Auditing Interpretation and Audit Issues Task Force Advisory**

.223 Presented below are descriptions of a new auditing Interpretation and a recently issued Audit Issues Task Force (AITF) Advisory that have special significance for auditors of financial institutions. As stated above, auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a comprehensive list and description of new auditing interpretations and AITF advisories.

#### ***Interpretation No. 1, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125," of SAS No. 73***

.224 Issued in February 1998, Interpretation No. 1, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125," of SAS No. 73, *Using the Work of a Specialist* (AU sec. 9336.01-.18), provides guidance regarding the use of a legal specialist's findings as audit evidence to support management's assertion that a transfer of financial assets meets the legal isolation criterion of paragraph 9(a) of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Current Text*, vol. 1, sec. F38). The Interpretation addresses when the

use of a legal specialist's work may be appropriate; factors that should be considered in assessing the adequacy of the legal response; and the use, as audit evidence, of legal responses that are restricted to the client's use. The Interpretation is effective for auditing procedures related to transactions required to be accounted for under FASB Statement No. 125 that were entered into on or after January 1, 1998. The AITF has amended the Interpretation to include the form of letter that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion as well as sample language that does not adequately communicate such permission. The amended Interpretation appeared in the October 1998 issue of the *Journal of Accountancy*.

### ***AITF Advisory, Practice Issues Regarding Language to Permit the Use of Legal Opinions by Auditors***

.225 In February 1998, the AITF issued an Interpretation, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of FASB Statement No. 125," of SAS No. 73. (Note that the guidance in this AITF Advisory has been incorporated into an amendment of the interpretation that appeared in the October *Journal of Accountancy*.) Paragraph 16 of the interpretation notes that if a legal letter restricts use of the findings expressed therein to the client or to third parties other than the auditor, the auditor should request that the client obtain the legal specialist's written permission for the auditor to use the opinion for the purpose of evaluating management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 125.

.226 The AITF has been made aware that some legal letters addressed to clients authorize the client to make copies of the legal opinion available to auditors to use in their evaluation of management's assertion that a transfer of financial assets meets the isolation criterion of FASB Statement No. 125, but then state that the auditor is not authorized to rely thereon. The AITF is advising auditors that, effective with the publication of this Advisory, such "use but not rely on" language, or other language that similarly restricts the auditor's use of the legal specialist's opinion, should not be used as audit evidence. The auditor may wish to consult with his or her legal counsel in circumstances in which it is not clear that the auditor may use the legal specialist's opinion.

## **New FASB Pronouncements**

### ***What new standards have been issued by the FASB?***

.227 Presented below are descriptions of recently issued FASB Statements that affect the financial statements of financial institutions. Auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a complete listing and description of recent GAAP developments, including FASB Emerging Issues Task Force (EITF) consensus positions and AICPA Statements of Position. Call the AICPA at 1-888-777-7077 to order.

### ***FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106***

.228 In February 1998, the FASB issued Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (FASB, *Current Text*, vol. 1, secs. P16 and P40). FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statements No. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16), No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB,

*Current Text*, vol. 1, sec. P16), and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40), were issued. Statement No. 132 suggests combined formats for presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

.229 Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

### **FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities***

.230 In June 1998, the FASB issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (b) a hedge of the exposure to variable cash flows of a forecasted transaction; or (c) a hedge of the foreign-currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.231 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.232 For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair-value hedge), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

.233 For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash-flow hedge), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

.234 For a derivative designated as hedging the foreign-currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair-value hedge described above applies to a derivative designated as a hedge of the foreign-currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign-currency exposure of a foreign-currency-denominated forecasted transaction.

.235 For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.236 Under FASB Statement No. 133, an entity that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

.237 FASB Statement No. 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction, except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign-currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

.238 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign-currency-forecasted transaction with a derivative. It supersedes FASB Statements No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107 to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. Statement No. 133 also nullifies or modifies the consensus reached in a number of issues addressed by the EITF.

.239 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

### **FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65***

.240 In October 1998, the FASB issued Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65*. FASB Statement No. 65, as amended by FASB Statements No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that, after the securitization of a mortgage loan held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed security as a trading security. This Statement further amends Statement No. 65 to require that after the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed securities or other retained interests based on its ability and intent to sell or hold those investments. This Statement conforms the subsequent accounting for securities retained after the securitization of mortgage loans by a mortgage banking enterprise with the subsequent accounting for securities retained after the securitization of other types of assets by a nonmortgage banking enterprise.

.241 This Statement shall be effective for the first fiscal quarter beginning after December 15, 1998. Early application is encouraged and is permitted as of the issuance of this Statement. On the date this Statement is initially applied, an enterprise may reclassify mortgage-backed securities and other beneficial interests retained after the securitization of mortgage loans held for sale from the trading category, except for those with sales commitments in place.<sup>3</sup> Those securities and other interests shall be classified based on the entity's ability and intent, on the date this Statement is initially applied, to hold those investments. Transfers from the trading category that result from implementing this Statement shall be accounted for in accordance with paragraph 15(a) of FASB Statement No. 115.

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<sup>3</sup> Mortgage-backed securities and other beneficial interests may be reclassified from the trading category when initially applying this Statement without regard for the provisions in paragraph 15 of FASB Statement No. 115, which states that "given the nature of a trading security, transfers into or from the trading category . . . should be rare."

## Proposed Interpretation or Amendment of FASB Statement No. 125

.242 The FASB is currently deliberating proposed Interpretations or a proposed Amendment of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The issues the FASB plans to address in these deliberations are as follows.

- The impact of the powers of the FDIC as receiver for a failed financial institution on the isolation of transferred assets under paragraph 9(a) of FASB Statement No. 125
- The effects of conditions that may constrain a transferee's ability to pledge or exchange transferred assets on the accounting for those transfers
- Circumstances in which a special-purpose entity (SPE) with the ability to sell transferred financial assets can be considered qualifying under the criteria in paragraph 26 of FASB Statement No. 125
- The effect of provisions that entitle a transferor to repurchase or redeem transferred assets (including the impact of "removal of accounts provisions") on the accounting for those transfers
- Conditions for deciding whether a transferor that transfers financial assets to a qualifying SPE should include the SPE in its consolidated financial statements
- The initial measurement of retained interests in transferred financial assets and the subsequent measurement of those retained interests and of new assets or liabilities received as proceeds of a sale
- Whether transfers of financial assets measured using the equity method of accounting should continue to be included in the scope of FASB Statement No. 125
- Whether the disclosure requirements in paragraph 17 of FASB Statement No. 125 should be enhanced to disclose (1) assumptions used to measure the fair value of "new" financial instruments or to allocate the carrying amount sold and retained interests resulting from transfers of financial assets, (2) the volume of transfers and resulting gains and losses during the period, and (3) continuing rights or obligations to repurchase transferred financial assets
- Whether to modify certain conditions for the recognition of transferred collateral included in paragraph 15 of FASB Statement No. 125

Readers should go to the following Web site for complete information on these issues: [www.rutgers.edu/Accounting/raw/fasb/project/fas125.html](http://www.rutgers.edu/Accounting/raw/fasb/project/fas125.html). The information on this Web site includes tentative decisions reached by the FASB regarding the above issues. An exposure draft of the proposed Interpretation or Amendment is expected to be issued during the fourth quarter of 1998. Also, the FASB is working on an implementation guide for FASB Statement No. 125, to answer various questions related to the pronouncement.

.243 Auditors should keep abreast of the status of the proposed interpretation or amendment, and the implementation guide, based upon the relevancy of these issues to their clients.

## References for Additional Guidance

*What are some organizations that can provide more information about the industry?*

.244 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.

.245 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.

.246 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.

.247 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

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.248 This Audit Risk Alert replaces the *Depository Institutions and Lending Industry Developments—1997/98* Audit Risk Alert.

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.249 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in the general *Audit Risk Alert—1998/99* [AAM section 8010] and *Compilation and Review Alert—1998/99* [AAM section 8015], which may be obtained by calling the AICPA Order Department at 1- 888-777-7077.

.250 The *Depository Institutions and Lending Industry* Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may email these comments to [RDurak@aicpa.org](mailto:RDurak@aicpa.org), or write to:

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## Appendix

### Year 2000 Question-and-Answer Guidance—External Auditor Involvement

1. Do auditors provide assurance on an entity's year 2000 readiness (or whether an entity's systems are year 2000 "compliant"), as a result of performing a financial statement audit?

No. An auditor's opinion on financial statements does not provide assurance on an entity's year 2000 readiness.

The objective of an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS) is to form an opinion on whether the financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP). Thus, auditors are focused on assertions embodied in the financial statements. In performing an audit conducted in accordance with GAAS, the auditor has responsibility to plan and perform the audit to obtain reasonable assurance about whether financial statements are free of material misstatement. This responsibility relates to detection of material misstatements in the financial statements being audited, whether caused by the year 2000 or by some other cause. An auditor does not have responsibility to detect current or future effects of the year 2000 on operational matters that do not affect an entity's ability to prepare financial statements in accordance with GAAP.

The AICPA has published year 2000 guidance for auditors, which is available on its Web site at <http://www.aicpa.org/members/y2000/index.htm>. The guidance includes interpretations issued by the AICPA Auditing Standards Board.

2. In an audit of financial statements conducted in accordance with GAAS, what is the auditor's responsibility regarding the Year 2000 Issue?

In the planning the audit, auditors consider, among other matters, the entity's methods to process significant accounting information. In doing so, the auditor may determine that it is necessary to consider whether data-processing errors caused by the Year 2000 Issue could result in a material misstatement of the financial statements under audit. The results of the consideration may affect the auditor's testing of internal controls and substantive audit procedures. However, auditors are not required to assess whether data-processing errors caused by the Year 2000 Issue could result in material misstatements of financial statements in periods subsequent to the period under audit.

3. What if, during the course of an audit, the auditor becomes aware that the entity's computer programs, which are correctly processing current data, would not function correctly if used to process data in the year 2000?

In all likelihood, the auditor will report this condition to management or the board of directors. However, because the computer programs are correctly processing current data, and are not currently affecting the entity's ability to prepare financial statements, this situation is not a "reportable condition," and the auditor is not obligated by GAAS to report it.

This situation also may be a condition or event that indicates there could be substantial doubt about an entity's ability to continue as a going concern. The auditor is obligated to consider whether such conditions and events, in conjunction with other conditions and events, cast significant doubt on the entity's ability to continue as a going concern. The Auditing Standards Board issued Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.03-.27), to provide guidance to auditors on the application of SAS No. 59 to the year 2000.

4. Can a CPA state (or provide assurance) that an entity is year 2000 compliant?

No. Year 2000 compliance is an extraordinarily complex matter. The AICPA's professional standards allow independent accountants to provide assurance on subject matter or assertions when they are capable of evaluation against reasonable criteria. No reasonable criteria have been established for year 2000 compliance, and it would be very difficult to do so.

5. In an audit of financial statements, is the auditor required to determine compliance with regulations or regulatory guidelines on year 2000, including Federal Financial Institutions Examination Council guidance?

No. In performing an audit of financial statements in accordance with GAAS, the auditor considers how laws and regulations might affect the financial statements being audited. The auditor's responsibility to detect and report misstatements arising from illegal acts, including noncompliance with laws and regulations, depends on the relationship of the noncompliance with the financial statements. The auditor has a responsibility to plan and perform the audit to detect misstatements resulting from illegal acts that have a *direct and material* effect on the determination of financial statement amounts. Noncompliance with year 2000 regulatory guidance would *not* have a direct and material effect on the determination of financial statement amounts.

6. What is the nature of the services an independent accountant can provide to assist management and the Board of Directors in understanding or evaluating the entity's plans to address the year 2000?

Independent accountants are able to provide services to help entities address the problems associated with the year 2000. Two alternatives are generally available: agreed-upon procedures and consulting services. These engagements are very specific to the entity and are governed by the terms of the contract between the parties.

In an agreed-upon procedures engagement, the independent accountant is engaged to perform procedures agreed upon by the accountant and all the specified users of the accountant's report. No assurance is expressed by the accountant; rather, the accountant reports the procedures performed and the findings. Each user of the report must agree to take responsibility for the sufficiency of the procedures for their purposes, since they best understand their own needs. In this type of engagement, the entity is usually the user of the report; however, other parties also may be users, provided they take responsibility for the sufficiency of the procedures performed. Use of the report is restricted to the users specified in the report.

In a consulting engagement, the nature and scope of the work and the matters to be reported are determined solely by agreement between the independent accountant and the entity. No assurance is expressed by the independent accountant. Such services ordinarily are performed only for the use and benefit of the entity.

An independent accountant can be engaged by an entity to assist with many aspects of its year 2000 plans. Such services may relate to, for example, the institution's year 2000 testing plan, the year 2000 contingency plan, or understanding the institution's year 2000 processes and related regulatory guidance. An independent accountant is not required to make available to financial institution examiners working papers related to those types of engagements.

Some independent accountants do not have the necessary resources to provide, or are not interested in providing, such services. There is no obligation that they do so.

**Information Sources**

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Organization	General Information	Fax Services	Internet	Recorded Announcements
<b>American Institute of Certified Public Accountants</b>	<i>Order Department</i> Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	www.aicpa.org	AcSEC Telephone Line (212) 596-6008
<b>Financial Accounting Standards Board</b>	<i>Order Department</i> 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)
<b>Federal Home Loan Mortgage Corporation (Freddie Mac)</b>	<i>Customer Service</i> 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE		www.fhlmc.org	
<b>Federal Deposit Insurance Corporation</b>	<i>Corporate Communication</i> 550 17th Street, NW Washington, DC 20429-0001 (202) 416-6940	Facsimile Bulletin Board System (804) 642-0003/2036	www.fdic.gov	Action Update (202) 898-7210
<b>Federal Reserve System</b>	<i>Publications Services</i> 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
<b>Mortgage Bankers Association of America</b>	<i>Publications Department</i> 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	

(Continued)

## Information Sources (cont'd)

Organization	General Information	Fax Services	Internet	Recorded Announcements
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 www.ncua.gov	Newsline (800) 755-1030 (703) 518-6339 (Washington, DC area)
U.S. Department of the Treasury - Office of the Comptroller of the Currency	Publications Control P.O. Box 70004 Chicago, IL 60673-0004 (202) 874-5000	OCC Information Line (202) 479-0141	www.ustreas.gov	
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## AAM Section 8060

# *Employee Benefit Plans Industry Developments—1999*

### NOTICE TO READERS

This Audit Risk Alert is intended to provide auditors of financial statements of employee benefit plans with an overview of recent industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff and the AICPA Employee Benefit Plans Committee. It has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. The AICPA staff wishes to thank the Office of the Chief Accountant of the U.S. Department of Labor Pension and Welfare Benefits Administration for contributing to this Audit Risk Alert.

### In This Year's Alert . . .

- What are the current industry conditions employee benefit plans are facing?
- What is the Year 2000 Issue and how will it affect your audits?
- What guidance has the DOL issued regarding the Year 2000 Issue?
- When will the DOL reject an annual report of a multiemployer health and welfare benefit plan, qualified due to a failure to comply with the requirements of SOP 92-6?
- When will the new Form 5500 become effective?
- What should you know about the legislative proposal "The ERISA Enforcement Improvement Act of 1999"?
- What information should an audit report include when SOP 92-6 is first adopted and the updated report on prior period financial statements has a different opinion from the opinion previously expressed?
- What new accounting standards that affect employee benefit plans have been proposed or issued recently?

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### Industry Developments

*What are the current industry conditions employee benefit plans are facing?*

**.01** This year saw a continued emphasis on individuals providing for their own financial retirement. The number of investment choices offered by 401(k) plans continues to grow. More and more 401(k) plans offer employer stock as an option, and with the stock market as favorable as it has been, employer stock accounts for a large portion of many 401(k) plans. However, in light of the volatility of financial markets, auditors

should continue to be particularly sensitive to concerns about the valuation of plan investments—especially derivative products<sup>1</sup>—and the adequacy of related disclosures.

.02 Many plans are now offering their participants online access to their 401(k) plans either through the Internet or Intranet. A 1998 survey performed by Merrill Lynch found that 12 percent of companies are now using a Web site for communications relating to employees' retirement plans. This is up from 8 percent a year earlier. Making access to retirement plans easier encourages employees to take advantage of these savings plans. Online access enables plan participants to review their accounts and change their investment elections at any time, even from home. Such an environment is a good vehicle for educating participants and allows them to perform such tasks as:

- Daily transfers
- Loans modeling and initiation, including review and approval of loan
- Statements on demand
- Salary deferral changes
- Enrollment
- Retirement remodeling
- Confirming balances

.03 Because plan participants can change their investments daily, by phone, or via Internet or Intranet sites, daily valuations of such plans are becoming more commonplace. More and more these services are being "bundled" and provided by one service provider. These service providers execute transactions and maintain accountability on behalf of the plan administrator. For example, outside service organizations such as recordkeepers, bank trust departments, 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. In fact, many plan sponsors no longer maintain records such as participant enrollment forms detailing the contribution percentage and the allocation by fund option, and this amount can be changed by telephone or online without any record. In these situations, the auditor may not be able to obtain a sufficient understanding of internal controls 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. This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

.04 The auditor should read the entire SAS No. 70 document to determine the scope of the engagement (the applications covered), the period covered, the tests performed, and the results of the tests, including instances of noncompliance. This information can be found in the auditor's report and in the body of the document (where the tests and results of testing are described). If the service organization's SAS No. 70 report identifies instances of noncompliance with the service organization's controls, the plan auditor should consider the effect of the findings on the assessed level of control risk for the audit of the plan's financial statements and, as a result, the plan auditor may decide to perform additional tests at the service organization or, if possible, perform additional audit procedures for the plan. In certain situations, the SAS No. 70 report may identify instances of noncompliance with the service organization's controls but the plan auditor concludes that no additional tests or audit procedures are required because the noncompliance does not affect the assessment of control risk for the plan.

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<sup>1</sup> In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 2, sec. D50), which establishes accounting and reporting standards for derivative instruments. FASB Statement No. 133 applies to employee benefit plans. See "New FASB Pronouncements" section of this Audit Risk Alert for a more detailed discussion of FASB Statement No. 133.

.05 If during the planning phase of an audit, a SAS No. 70 report is not available from the service provider, the user auditor should consider information available at the user organization about the controls at the service organization (for example, user manuals, system overviews, technical manuals, and so on). If the user auditor concludes that the available information is not adequate to obtain a sufficient understanding of the service organization's controls to plan the audit, consideration should be given to having the auditor and plan sponsor call the service provider directly and ask specific questions that will enable the auditor to document his or her understanding of the internal controls at the service provider. The auditor may also consider confirming certain parameters, such as copayment deductibles, directly with the service provider.

.06 Further, when SAS No. 70 reports are not available auditors may consider confirming directly with participants—

- Specific changes made to their elections throughout the year.
- Year-end balances.

Auditors may be able to obtain printouts of the daily activity from the service provider throughout the year to confirm directly with the participants. Auditors should keep in mind that in the daily valuation environment, many service providers are on the cash basis and auditors should be alert to accrual basis adjustments, for example, contributions receivable reconciliation between the recordkeeper and the trustee.

## Year 2000 Issue

*What is the Year 2000 Issue and how will it affect your audits?*

.07 As we move closer to the year 2000, the Year 2000 Issue becomes more critical for auditors. Problems resulting from the millennium bug may have significant effects on clients currently, which auditors will need to address. One of the many issues discussed regarding the Year 2000 Issue is that the year 2000 is a leap year. Systems that are not year-2000-ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur in 1999. For example, some software programs may have assigned special meanings to entries date-coded as "XX/XX/99" to allow for the testing of software modifications. Therefore actual transactions using such dates may not be processed correctly or may stop functioning. Failures may also take place in 1999 when systems perform calculations into or beyond the year 2000.

.08 Unless these year 2000 problems are remedied, significant problems relating to the integrity of electronically processed information based on time may occur. To further complicate the issue, even if a plan's computer software and hardware have been modified to resolve the problem, the entity may be affected by the computer systems of third-party data processing services, third-party administrators, actuaries, plan sponsors, or claims administrators that have not made such modifications. The Year 2000 Issue may affect the ability of a service organization's computerized systems to provide services to employee benefit plans. This in turn may affect the ability of employee benefit plans to record, process, summarize, and report financial data. For example, a system unprepared for the year 2000 might fail to recognize when an active participant has attained normal retirement age to qualify for full vesting under the plan. Other areas related to age or service that could be affected include the following:

- Eligibility requirements
- Reinstatement of forfeited account balances
- Funding calculations and lump-sum distribution calculations
- Defined contribution age or service allocations
- Nondiscrimination testing
- Start dates for required minimum distribution

- Employee stock ownership plan (ESOP) diversification rights
- Qualified domestic relations orders (QDROs)
- Early retirement supplements
- Postretirement medical benefits
- Funding assumptions for postretirement benefits in a funded welfare plan
- Benefit calculations based on relevant Financial Accounting Standards Board (FASB) Statements

It is the responsibility of an entity's management—not the auditor—to assess and remediate the effects of the Year 2000 Issue on an entity's systems. Under generally accepted auditing standards (GAAS), 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Year 2000 Issue or by some other cause.

.09 Auditing guidance relating to the Year 2000 Issue has been developed by the Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB). The AITF has issued the following auditing Interpretations:

- Interpretation No. 4, "Audit Considerations for the Year 2000 Issue," of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311.38), discusses the auditor's responsibility for the Year 2000 Issue, how it affects planning for an audit of financial statements conducted in accordance with GAAS, and in what circumstances the Year 2000 Issue may result in a reportable condition under SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).
- Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19), addresses the responsibilities of service auditors with respect to information about the Year 2000 Issue in a service organization's description of controls.
- Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.03), provides guidance regarding the identification and evaluation of conditions and events of the type identified in SAS No. 59 that relate to the Year 2000 Issue.

Auditors should be aware of the auditing and accounting issues that arise from the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, impairment, revenue and expense recognition, and disclosure. A more comprehensive discussion of this topic can be found in *Audit Risk Alert—1998/99* [AAM section 8010].

## Department of Labor (DOL) Issues Guidance on Year 2000 Compliance

*What guidance has the DOL issued regarding the Year 2000 Issue?*

.10 On December 14, 1998, the U.S. DOL Pension and Welfare Benefits Administration (PWBA) issued a press release addressing concerns about fiduciary liability and the year 2000 computer problem. To help the employee benefit industry understand these issues, the PWBA released sample questions used by its investigators to evaluate year 2000 compliance in the course of investigations of benefit plans across the United States. This release was in response to hundreds of inquiries from concerned employee benefit plan administrators and trustees and from their service providers who want to know what information the PWBA is seeking from the plans to show they are working to solve their internal computer problems and to avert



any potential disruption in service to their participants and beneficiaries. Like most business operations, employee benefit plans rely on computers to perform critical operations such as benefit calculations and payments. The sample fiduciary questions have been reprinted in appendix B [paragraph .73], "Sample Fiduciary Questions Regarding The Year 2000 Problem," of this Audit Risk Alert and are available on the PWBA's Web site: <http://www.dol.gov/dol/pwba>.

.11 Earlier in 1998, the PWBA issued two news releases emphasizing that plans need to address year 2000 issues relating to their own computer systems. In addition, the agency widely distributed a Year 2000 Issue pamphlet on commonly asked questions and answers. "PWBA Year 2000 Questions and Answers" is reprinted in appendix C [paragraph .74] of this Audit Risk Alert and is also available on the PWBA's Web site: <http://www.dol.gov/dol/pwba>. The pamphlet concentrates on the fiduciary liability of plan officials and service providers in addressing the Year 2000 Issue in connection with any computer systems their plans utilize.

#### Note

Internet Web sites that might provide useful year 2000 information to auditors include the following:

PWBA Web site—<http://www.dol.gov/dol/pwba>

AICPA Web site—<http://www.aicpa.org>

The National Bulletin Board for the Year 2000—<http://www.year2000.com>

Management Support Technology—<http://www.msnet.com/year2000>

#### Executive Summary—Year 2000 Issue

- Unless corrective actions are taken, the year 2000 may cause accounting and financial information systems to produce inaccurate date-related output.
- The Audit Issues Task Force has issued Interpretations providing guidance to auditors on the Year 2000 Issue.
- Several auditing and accounting issues arise from the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, impairment, and disclosure. A more comprehensive discussion of this topic can be found in *Audit Risk Alert—1998/99* [AAM section 8010].
- The Pension and Welfare Benefits Administration (PWBA) of the DOL has issued guidance for plan administrators and service providers regarding the Year 2000 Issue, including posting Sample Fiduciary Questions and Qs&As on its Web site. Such guidance has also been reprinted in appendixes B and C [paragraphs .73 and .74] of this Audit Risk Alert.

## Regulatory Developments

*When will the DOL reject an annual report of a multiemployer health and welfare benefit plan, qualified due to a failure to comply with the requirements of SOP 92-6?*

### DOL Nonenforcement of GAAP Disclosures of Postretirement Benefit Obligations by Multiemployer Health and Welfare Benefit Plans

.12 On November 25, 1998, the PWBA announced that it will not adopt a proposed nonenforcement policy affecting Form 5500s filed by multiemployer health and welfare benefit plans. Accordingly, annual reports of multiemployer health and welfare benefit plans filed for plan years commencing on or after January 1, 2000, will be subject to rejection by the PWBA if there is any material qualification in the accountant's opinion accompanying the annual report due to a failure to comply with the requirements of Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*.

.13 To ensure that multiemployer health and welfare plans have an adequate opportunity to prepare their financial recordkeeping and other related systems to comply with SOP 92-6, the PWBA also stated that these plans may continue to rely on its previously announced interim nonenforcement relief for their 1999 Form 5500 reports. It is important to point out, however, that SOP 92-6 requires restatement of prior period financial statements only if they are presented together with the current year's financial statements. Therefore, when SOP 92-6 is adopted for plan year 2000, it will be necessary to restate the 1999 statement of net assets to comply with the provisions of SOP 92-6. Plan administrators should consider engaging an actuary in 1999 to perform the calculations for the 1999 plan year. Plan administrators who rely on the interim relief must, however, comply with the AICPA's pre-SOP 92-6 requirements in their financial statement treatment of the matters now covered by SOP 92-6. See the section entitled "Multiemployer Health and Welfare Benefit Plan Accounting for Postretirement Benefit Obligations" in this Audit Risk Alert for further discussion of this issue.

## Update on the Proposed Revisions of the Form 5500 Series

### *When will the new Form 5500 become effective?*

.14 On June 23, 1998, the DOL, Internal Revenue Service (IRS), and Pension Benefit Guaranty Corporation (PBGC) submitted the new Form 5500 to the Office of Management and Budget (OMB) for approval under the Paperwork Reduction Act. The submission to OMB followed the completion of the agencies' evaluation of more than sixty public comments and a day of testimony from employer groups, employee representatives, financial institutions, service organizations, and others, on the form streamlining proposal that was published in the *Federal Register* in September 1997. Following OMB's review and approval of the new data collection form, the final computer-scannable forms that will be mandatory for 1999 plan year filings and electronic filing options will be developed and published in the *Federal Register*. The Form 5500 Annual Return/Report is used by more than 800,000 pension, welfare, and fringe benefit plans that file information with the federal government. The new Form 5500 is intended to streamline the report and the methods by which it is filed and processed. The proposal was patterned after tax returns familiar to individuals and corporate taxpayers—a simple, one-page main form with basic information and a checklist that guides each filer to the more detailed schedules that are applicable to the filer's specific type of plan.

.15 Since the Employee Retirement Income Security Act of 1974 (ERISA) requires the attachment of several schedules to the Form 5500, auditors should be aware of several changes. The most notable changes follow.

#### *Information on Which Auditors Are Required to Report*

- *Schedule G (Financial Transaction Schedules)*—As a result of a planned shift to computer-scannable forms, the use of this schedule will be mandatory for reporting loans, leases, and fixed income obligations in default or uncollectible, and prohibited transactions.
- *Schedule of Assets Held for Investment Purposes and Schedule of Reportable Transactions*—Plans that have assets held for investment purposes and reportable transactions will continue to complete these schedules. While no mandatory form is required for this information, the instructions provide the format for the schedules. Auditors should note:
  - Historical cost information is no longer required on the Schedule of Assets Held for Investment Purposes for participant-directed investments.
  - Participant or beneficiary-directed transactions are no longer required to be taken into account for purposes of preparing the Schedule of Reportable Transactions.
  - In a plan's initial year, the 5 percent threshold for the schedule of reportable transactions is based on the end-of-year balance of the plan's assets.

#### *Changes to Other Schedules*

- *Schedule A (Insurance Information)*—Information required by this schedule will now be permitted to be reported on an insurance contract or policy year basis.

- *Schedule C (Service Provider Information)*—This schedule will be limited to the top forty paid service providers and will require explanations of service provider terminations for only accountants and enrolled actuaries. In addition, this schedule eliminates the requirement to identify plan trustees annually.
- *Schedule D (Direct Filing Entity[DFE]/Participating Plan Information)*—This schedule was created as part of an overall effort to make the Form 5500 the standardized reporting format for all filers. It was also part of the proposal to standardize the way information is filed about insurance company pooled separate accounts (PSAs), bank common or collective trusts (CCTs), master trust investment accounts (MTIAs), 103-12 investment entities (103-12 IEs), and group insurance arrangements (GIAs).
- *Schedule H (Financial Information for Large Plans and DFEs)*—This schedule contains the financial information formerly contained in the Form 5500 and a series of questions regarding activities of the plan. Additional guidance has been provided on reporting “deemed distributions” of participant loans, “corrective distributions” from pension plans and “incurred but not reported” (IBNR) claims for welfare plans.

.16 The DOL is simultaneously developing a new computerized system to process the Form 5500 (the ERISA Filing Acceptance System or “EFAST”) to reduce government and filer costs associated with filing, receiving, and processing annual reports. The new computerized system will simplify and expedite the receipt and processing of the Form 5500 by relying on computer-scannable forms and electronic filing technologies.

.17 On December 10, 1998, the DOL published in the *Federal Register* a notice proposing amendments to ERISA’s reporting and disclosure regulations. These amendments would make technical and conforming changes to the regulations necessary to implement the revised Form 5500 Series. Among other changes, the proposed regulatory amendments would update the references in sections of ERISA to reflect the new structure of the Form 5500 Series:

- Section 2520.103 provides for special reporting rules for plans that participate in a master trust. The proposed amendments do not change the information required to be reported regarding the master trust, but rather establish the Form 5500 Series as the standard reporting format for master trusts.
- Section 2520.103-12 provides an exemption and an alternative method of reporting for plans investing in certain investment entities, the assets of which are deemed to include plan assets under Section 2520.103-101. The proposed amendments do not change the information required to be reported by the 103-12 investment entity, but rather establish the Form 5500 Series as the standard reporting format.
- Section 2520.103-5 implements Section 103(a)(2) of ERISA, which deals with insurance carriers or other organizations that provide some or all of the benefits under a plan or hold plan assets, and banks or similar institutions that hold plan assets. In the case of CCTs or PSAs, the proposed amendments would require that such CCTs or PSAs notify their participating plans of whether or not they intend to file a Form 5500 as a new direct filing entity, and to furnish the plan administrators with the information about the assets held by such CCTs or PSAs needed by the plan administrators to satisfy their obligations under Title I of ERISA.

## PWBA Review of Plan Audits

.18 The PWBA has established an ongoing quality review program to assess the quality of audit work performed by independent auditors in audits of plan financial statements that are required by 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. Because ERISA holds plan administrators responsible for assuring that plan financial statements are audited in accordance with GAAS, deficient audit work can also expose plan administrators to significant penalties under ERISA Section 502(c)(2).

.19 The PWBA continues its aggressive reporting compliance program to ensure that plan administrators comply with ERISA's reporting and disclosure requirements. The DOL's 1999 budget contained a major performance goal that no more than 12 percent of 1999 plan year audits would contain deficiencies with professional and regulatory standards and that no more than 3 percent of Form 5500 filings would contain reporting and disclosure deficiencies. During 2001, the PWBA plans to conduct a nationwide study to once again assess the quality of employee benefit plan audits and evaluate compliance with its goal.

### **AICPA Peer Review Developments**

.20 The AICPA, working with the PWBA, has made a concerted effort to improve the guidance and training available to auditors of employee benefit plans. The AICPA self-regulatory teams continue to be concerned about deficiencies noted on audits of employee benefit plans, and practitioners need to understand that severe consequences can result from inadequate plan audits, including loss of membership in the AICPA and loss of license. Some common recurring deficiencies noted by the AICPA Peer Review Board in its review of employee benefit plans follow:

- Inadequate testing of participant data
- Inadequate testing of investments
- Failure to understand testing requirements on a limited-scope engagement
- Inadequate or no documentation of the auditor's understanding of internal control
- Inadequate consideration of prohibited transactions
- Incomplete description of the plan and its provisions
- Inadequate or missing disclosures related to investments
- Inadequate or missing disclosures related to participant data
- Failure to properly report on or include the required supplemental schedules required by ERISA and DOL

The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* provides guidance concerning areas where the Peer Review Board noted deficiencies.

.21 In 1998 the AICPA Peer Review Board revised Interpretation No. 2, *Engagement Selection in On-Site Peer Reviews*. This Interpretation now requires that, among other types of engagements, an employee benefit plan engagement subject to ERISA be selected for review in an on-site peer review. The Interpretation states that

Regulatory and legislative developments have made it clear that there is a significant public interest in, and a higher risk associated with, audits conducted pursuant to the Employee Retirement Income Security Act of 1974 (ERISA). Therefore, if a firm performs the audit of one or more entities subject to ERISA, at least one such audit engagement conducted pursuant to ERISA should be selected for review.

*Standards for Performing and Reporting on Peer Reviews* (AICPA, *Professional Standards*, vol. 2, and *Peer Review Program Manual*, PRP sec. 3100.48), states that the AICPA Peer Review Board, by Interpretations, can require specific types of engagements to be selected for review.

### **Timeliness of Participant Contributions Remains an Enforcement Initiative for the PWBA**

.22 The PWBA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans. Participant contributions are required to be remitted as soon as they

can reasonably be segregated from an employer's general assets. A DOL regulation requires employers who sponsor pension plans (both defined benefit and defined contribution) to remit employee contributions as soon as practicable, but in no event more than fifteen business days after the month in which the participant contribution was withheld or received by the employer.

.23 The regulation establishes a procedure by which an employer may obtain an extension of the fifteen-business-day limit for an additional ten business days. This regulation does not change the maximum period for remittance of employee contributions to welfare plans, that is, as soon as practicable, but in no event more than ninety days after the day the contribution was withheld or received by the employer.

.24 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. GAAS requires that the auditor's report on financial statements included in an annual report filed with the DOL cover the information in the required supplementary schedules when they are presented along with the basic financial statements. If the auditor concludes that the plan has entered into a prohibited transaction, and the transaction has not been properly disclosed in the required supplementary schedule, the auditor should (a) express a qualified opinion or an adverse opinion on the supplementary schedule if the transaction is material to the financial statements, or (b) modify his or her report on the supplementary schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See chapter 11, "Party in Interest Transactions," of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for further discussion of prohibited transactions.

.25 For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 219-7461.

## **PWBA Outreach and Customer Service Efforts**

.26 The 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.

.27 In addition to handling technical telephone inquiries, the 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 the PWBA at its Web site: <http://www.dol.gov/dol/pwba>. The Web site provides information on PWBA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

## **Delinquent Filer Voluntary Compliance Program**

.28 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 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.

.29 Questions concerning the DFVC Program should be directed to the PWBA's Division of Reporting Compliance at (202) 219-8770. Practitioners and other members of the public may also wish to contact the PWBA at its Web site: <http://www.dol.gov/dol/pwba>.

### *PWBA Proposed Rule on Claims Procedures for Employee Benefit Plans*

.30 On September 9, 1998, the PWBA published a proposed rule to ensure plan participants a timely, fair internal review when they have a grievance against their health plan and an expedited review for urgent claims. On February 16–18, 1999, PWBA held public hearings to address the over 600 comment letters received from the public. One area of agreement was that the new rules should be rewritten to make a distinction between services that must be pre-authorized and claims that are paid after services have been provided.

.31 In addition, the PWBA published an interim amendment to its rules relating to the way health care plans explain coverage required by the Newborns' and Mothers' Health Protection Act of 1996. The interim amendment tells providers to disclose that a mother and baby may be discharged earlier than the minimum time an insurance plan must cover. Generally a health plan or health insurance issuer may not restrict benefits for any hospital stay to less than forty-eight hours for most deliveries and ninety-six hours for a cesarean section. What may not have been clear in plan disclosures was that an attending provider (such as a physician or licensed nurse midwife) may discharge them sooner, although only after consultation with the mother.

### *Section 401(k) Plan Fees*

.32 On July 1, 1998, the DOL released "A Look at 401(k) Plan Fees," a 19-page, educational booklet to help consumers understand the fees and expenses associated with 401(k) plan accounts. The booklet answers commonly asked questions regarding plan fees and expenses, highlights the most common fees, and encourages participants to make informed investment decisions, consider fees as one of several factors when making a decision, compare all services received with the total cost, and realize that cheaper is not necessarily better. The booklet is available from the PWBA's Publication Hotline at (800) 998-7542 and on the PWBA's Web site at: <http://www.dol.gov/dol/pwba>. In addition, the PWBA is making available on its Web site the results of recent research on the subject. "Study of 401(k) Plan Fees and Expenses" examines current practices relating to which fees and expenses are paid by employers sponsoring 401(k) plans and which are paid by employees participating in the plan.

### *National Summit on Retirement Savings*

.33 The first National Summit on Retirement Savings, called for by the Savings Are Vital to Everyone's Retirement Act of 1997 (SAVER Act) was held on June 4–5, 1998, in Washington, DC. The Summit was co-hosted by the President and the congressional leadership in the House and Senate. The SAVER Act calls for a second Summit in 2001 and a third in 2005.

.34 The purpose of the Summit was to increase public awareness of the importance of retirement planning and to identify ways to promote greater retirement savings by all Americans. The final report on the 1998 National Summit on Retirement Savings was published on September 3, 1998, and may be found on the PWBA's Web site at: <http://www.dol.gov/dol/pwba>.

### *Health Benefits Education Campaign*

.35 On December 16, 1998, the DOL launched a national health benefits education campaign designed to help millions of working Americans understand their medical benefits when they experience changes in life and work—such as marriage, childbirth, job layoff, or retirement. Seventy public and private organizations have joined this education campaign and will help distribute three new brochures to advise workers and spouses covered by employer-sponsored health plans.

.36 The brochures are available through the DOL's publication hotline at (800) 998-7542 or its Web site at: <http://www.dol.gov>. The titles are "Top 10 Ways to Make Your Health Benefits Work for You," "Changes in Your Work Status May Affect Your Health Benefits," and "Life Changes Require Health Choices—Know Your Options."

*DOL Announces Procedure for State-Registered Investment Advisers to Obtain ERISA Investment Manager Status*

.37 On January 14, 1998, the DOL announced a new procedure that state-registered investment advisers must follow in order to obtain investment manager status under federal pension law. Under Public Law 105-72, signed into effect on November 10, 1997, state-registered investment advisers seeking investment manager status under ERISA must file with the DOL a copy of their most recently filed state registration form and any subsequent filings. Generally, the new filing requirement applies to investment advisers who manage less than \$25 million and who are required to register under state law. Advisers who are required to register in multiple states need only provide the department a copy of the registration form filed in the state where they maintain their principal office and place of business.

.38 Investment advisers could initially file their registration forms with the department any time prior to November 10, 1998, to satisfy the new requirement for ERISA investment manager status. Any subsequent filings with the state should be filed with the department at the same time. The PWBA has prepared a brief on the new filing requirement. Copies may be obtained by calling the DOL's Publication Hotline at (800) 998-7542. This brief, along with other publications concerning ERISA provisions that may be applicable to investment advisers, is also available on the PWBA's Web site at: <http://www.dol.gov/dol/pwba/public/pubs/brief2.htm>.

*DOL Proposes Rule on Electronic Communications and Recordkeeping by Employee Benefit Plans*

.39 On January 29, 1999, the DOL issued proposed regulations addressing electronic communications of certain information by employee benefit plans and minimum standards for maintenance and retention of employee benefit records in electronic form.

.40 The proposed rule on electronic communications expands to pension and other welfare plans the existing "safe harbor" for group health plans using electronic media to furnish summary plan descriptions and summaries of material modifications to plan participants. The proposal also would expand the "safe harbor" to cover summary annual reports. In addition, the proposed rule would provide minimum standards regarding the use of electronic media for the maintenance and retention of records under ERISA.

**Executive Summary—Regulatory Developments**

- The PWBA announced that it will not adopt a proposed nonenforcement policy affecting Form 5500s filed by multiemployer health and welfare benefit plans. Accordingly, annual reports of multiemployer health and welfare benefit plans filed for plan years commencing on or after January 1, 2000, will be subject to rejection by the PWBA if there is any material qualification in the accountant's opinion accompanying the annual report due to a failure to comply with the requirements of SOP 92-6.
- Since SOP 92-6 requires restatement of prior period financial statements, plan administrators should consider engaging an actuary in 1999 to perform the calculations for the 1999 plan year as the actuarial amounts will be needed for the financial statements issued for plan year 2000.
- Pending approval from the OMB, the new Form 5500 schedules will become effective for the 1999 plan year filings.
- The AICPA Peer Review Board revised Interpretation No. 2, *Engagement Selection in On-Site Peer Reviews*. This Interpretation requires that, among other types of engagements, an employee benefit plan engagement subject to ERISA be selected for review in an on-site peer review.

## Legislative Developments

*What should you know about the legislative proposal  
"The ERISA Enforcement Improvement Act of 1999"?*

### Pension Audit Legislation

.41 The Administration has developed a legislative proposal, "The ERISA Enforcement Improvement Act of 1999," aimed at improving the quality and integrity of employee benefit plans. The proposal includes:

1. Retaining the limited-scope audit provision in lower risk circumstances where:
  - a. At least 95 percent of a plan's assets have a "readily ascertainable market value";
  - b. The regulated financial institution certifies to statements as "complete and accurate" and to the "current value" of each asset at the end of the plan year;
  - c. Within an eighteen-month period preceding the certification, the financial institution receives a GAAS report from an independent qualified public accountant (IQPA), which comments on the adequacy of the internal controls of the financial institution (or affiliates) pertaining to the execution, maintenance of accountability, recording, and processing of transactions related to plan or participant recordkeeping;
  - d. The certified information is considered part of the plan's annual report; and
  - e. The IQPA providing the certification satisfies the requirements of the proposal's enhanced auditor qualifications.
2. Enhancing ERISA's auditor qualifications by requiring IQPAs to undergo periodic external quality control reviews and complete continuing professional educational training related to employee benefit plan matters;
3. Requiring speedy reporting of serious ERISA violations and imposing substantial civil penalties on plan administrators and IQPAs who fail to comply with the notification provisions; and
4. Making 502(l) penalties discretionary. Section 502(l) penalties are mandatory civil penalties paid by plan fiduciaries that apply to amounts paid under "settlement agreements" or court orders in cases where the Secretary of Labor is a party.

## Audit Developments

*What information should an audit report include when SOP 92-6 is first adopted and the updated report on prior period financial statements has a different opinion from the opinion previously expressed?*

## Multiemployer Health and Welfare Benefit Plan Accounting for Postretirement Benefit Obligations

.42 Employee health and welfare benefit plans that prepare financial statements in accordance with generally accepted accounting principles (GAAP) must follow the accounting and reporting requirements set forth in chapter 4, "Accounting and Reporting by Health and Welfare Benefit Plans," of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, which incorporates the guidance of AICPA 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.

.43 Among other requirements, SOP 92-6 requires 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. Accounting changes adopted to conform to the provisions of the SOP should be made retroactively. 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.<sup>2</sup>

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<sup>2</sup> If accounting changes were necessary to conform to the provisions of Statement of Position (SOP) 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*, that fact should be disclosed when financial statements for the year in which the SOP is first applied are presented either alone or with financial statements of prior years.



.44 As noted in the “Regulatory Developments” section of this Audit Risk 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, 1997, 1998, and 1999. However, annual reports of multiemployer health and welfare benefit plans filed for plan years beginning on or after January 1, 2000, will be subject to rejection if there is any material qualification in the accountant’s opinion accompanying the annual report due to a failure to comply with the requirements of SOP 92-6. Since SOP 92-6 requires restatement of prior period financial statements, plan administrators should consider engaging an actuary in 1999 to perform the calculations for the 1999 plan year as the actuarial amounts will be needed for the financial statements issued on the year 2000.

.45 SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.68 and .69), provides guidance when an auditor has previously qualified his or her opinion or expressed an adverse opinion on financial statements of prior periods because of a departure from GAAP and the prior period financial statements are restated in the current period to conform with GAAP. SAS No. 58 requires the auditor’s updated report on the financial statements of the prior period to indicate that the statements have been restated and to express an unqualified opinion with respect to the restated financial statements. Further, when the updated report has a different opinion from the opinion previously expressed on the prior period financial statements, the auditor should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) preceding the opinion paragraph of his or her report. The explanatory paragraph(s) should disclose—

- a. The date of the auditor’s previous report.
- b. The type of opinion previously expressed.
- c. The circumstances or events that caused the auditor to express a different opinion.
- d. That the auditor’s updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements.

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.<sup>3</sup> SAS No. 58 describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from a generally accepted accounting principles (see AICPA, *Professional Standards*, vol. 1, AU sec. 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.

.46 Over the past two years, members of the AICPA Employee Benefit Plans Committee noted that when multiemployer plans did not adopt SOP 92-6 for postretirement benefit obligations, the postretirement benefit obligation amount was material enough that the financial statements taken as a whole were not fairly presented in conformity with GAAP and an adverse opinion was issued. The members of the committee also noted that only in rare instances, such as if very few retirees remained in the plan, was a qualified opinion issued. Further, when the plan administrator did not quantify the amount of or change in the plan’s postretirement benefit obligation, or in the absence of an actuarial determination, the committee members presumed the effects of the omission on the financial statements to be material.

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<sup>3</sup> The AICPA Employee Benefit Plans Committee currently has a proposed SOP on certain health and welfare benefit plan transactions that is awaiting FASB clearance for exposure. Among other things, this proposed SOP would allow the information about benefit obligations to be presented in a note to the financial statements. See the “Proposed Statements of Position for Employee Benefit Plans” section of this Audit Risk Alert for a further discussion of this proposed SOP.

.47 If the auditor issues an adverse opinion on the plan's financial statements, the auditor cannot express an opinion on the supplemental schedules required by ERISA. An expression of an opinion on the supplemental schedules in those circumstances would be inappropriate because it may overshadow or contradict the adverse opinion on the plan's basic financial statements. See SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, Professional Standards, vol. 1, AU sec. 551.10).

## 1999 Audit and Accounting Guide Revisions

.48 The following list summarizes some of the revisions that will be included in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), with conforming changes as of May 1, 1999.

- There are new sections on the following:
  - Auditing changes in actuaries
  - Auditing self-directed accounts
- The Guide has been updated to reflect FASB Statement No. 133.
- The SOP, *Accounting For and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans* will be included in the Guide.

## Accounting Developments

*What new accounting standards that affect employee benefit plans have been proposed or issued recently?*

## New FASB Pronouncements

### **FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities<sup>4</sup>**

.49 In June 1998, the FASB issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50). FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as *derivatives*), and for hedging activities. FASB Statement No. 133 applies to employee benefit plans. As such, certain investments held by plans will fall under this statement. Paragraph 43 of FASB Statement No. 133 provides specific guidance to entities that do not report earnings, such as defined benefit pension plans. Paragraphs 44 through 47 of FASB Statement No. 133 set forth the disclosure requirements.

.50 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of FASB Statement No. 133 should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of the Statement. Earlier application of all of the provisions of FASB Statement No. 133 is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of the Statement. FASB Statement No. 133 should not be applied retroactively to financial statements of prior periods.

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<sup>4</sup> FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It supersedes FASB Statements No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. FASB Statement No. 133 also nullifies or modifies the consensus reached in a number of issues addressed by the Emerging Issues Task Force (EITF).

## New AICPA Statements of Position

### **Statement of Position Accounting For and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans**

.51 As of April 1999, the *SOP Accounting For and Reporting of Postretirement Medical Benefit (401(h)) Features of Defined Benefit Pension Plans* was due to be released shortly. This SOP amends chapters 2 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), and specifies the accounting for and disclosure of 401(h) features of defined benefit pension plans, by both defined benefit pension plans and health and welfare benefit plans.

.52 The SOP requires—

1. Defined benefit pension plans to record assets held in a 401(h) account related to health and welfare plan obligations for retirees as both assets and liabilities on the face of the statement of net assets available for pension benefits in order to arrive at net assets available for pension benefits.
2. 401(h) account assets used to fund health and welfare benefits, and the changes in those assets, to be reported in the financial statements of the health and welfare benefit plan. Benefit obligations related to the 401(h) account are also required to be reflected in the health and welfare plan financial statements.
3. Defined benefit pension plans to disclose the fact that the assets are available only to pay retirees' health benefits.
4. Health and welfare benefit plans to disclose in the notes to the financial statements the fact that retiree health benefits are funded partially through a 401(h) account of the defined benefit pension plan.

The SOP is effective for financial statements for plan years beginning after December 15, 1998, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this SOP should be made retroactively.

## Proposed Statements of Position for Employee Benefit Plans

.53 The AICPA Employee Benefit Plans Committee currently has two SOP projects underway.

.54 *Accounting and Reporting for Certain Employee Benefit Plan Investments and Other Disclosure Matters*. The first proposed SOP, *Accounting and Reporting for Certain Employee Benefit Plan Investments and Other Disclosure Matters*, was cleared for exposure by the FASB at the February 24, 1999, meeting pending certain changes. This SOP was discussed at the March 8–9, 1999, AcSEC meeting for final clearance for exposure. The exposure draft is expected to be released in the second quarter 1999. This proposed SOP amends chapters 3 and 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the Guide), SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, and SOP 92-6. This proposed SOP simplifies disclosures for certain investments and would supersede AICPA Practice Bulletin (PB) 12, *Reporting Separate Investment Fund Option Information of Defined Contribution Pension Plans*.

.55 Specifically this proposed SOP—

- a. Revises Guide, paragraphs 3.28k and 3.28l and supersedes PB 12 to eliminate the required disclosures by defined contribution pension plans for participant-directed investment programs.
- b. Revises Guide, paragraph 3.20 to eliminate the required disclosures by defined contribution pension plans to present plan investments by general type in the statement of net assets available for benefits for participant-directed investment options.
- c. Revises Guide, paragraph 3.28g to require identification of those investments that represent 5 percent or more of net assets available for benefits that are nonparticipant-directed for defined contribution pension plans.

- d. Revises SOP 94-4, paragraph 15, SOP 92-6, paragraph 58, and Guide, paragraphs 3.28p and 4.57 to eliminate the required disclosures by investment fund option for defined contribution pension and health and welfare plans relating to benefit responsive investment contracts.

.56 This proposed SOP is effective for financial statements for plan years ending after December 15, 1999, with earlier application encouraged for fiscal years for which annual financial statements have not been issued. When the required "by-fund" disclosures of this statement are eliminated as proposed by this SOP, reclassification of comparative amounts in financial statements for earlier periods is required.

.57 *Accounting For and Reporting on Certain Health and Welfare Benefit Plan Transactions.* The second proposed SOP, on the accounting for and reporting on certain health and welfare benefit plan transactions, was discussed at the January 1999 AcSEC meeting and was cleared for exposure pending FASB clearance. The exposure draft is expected to be released for exposure in the second quarter of 1999. This proposed SOP amends chapter 4 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, and SOP 92-6. This proposed SOP revises the standards for measuring, reporting, and disclosing estimated future postretirement benefit payments that are to be funded partially or entirely by plan participants. It specifies the presentation requirements for benefit obligation information and establishes standards of financial accounting and reporting for certain postemployment benefits provided by health and welfare benefit plans. Specifically, it allows information about the benefit obligations to be presented in a separate statement, combined with other information in a financial statement, or presented in a note to the financial statements. The proposed SOP also clarifies the measurement date for benefit obligations and clarifies the identification of 5 percent investment disclosures.

.58 The provisions of this proposed SOP would be effective for financial statements for plan years beginning after December 15, 2000, with earlier application encouraged. Financial statements for prior plan years are required to be restated to comply with the provisions of this proposed SOP.

#### Note

Practitioners should note that the purpose of AICPA exposure drafts is to solicit comments from preparers, auditors, users of financial statements, and other interested parties. They are nonauthoritative and cannot be used as a basis for changing GAAP.

#### Executive Summary—Proposed Statements of Position

- *Accounting and Reporting for Certain Employee Benefit Plan Investments and Other Disclosure Matters* (expected to be released for exposure by the second quarter 1999)
- *Accounting For and Reporting on Certain Health and Welfare Benefit Plan Transactions* (expected to be released for exposure by the second quarter 1999)

## Professional Ethics Division Interpretations and Rulings

### Omnibus Proposal of Professional Ethics Division Interpretations and Rulings

.59 On February 18, 1999, the AICPA Professional Ethics Executive Committee adopted, with modification, most of the proposals from the November 1998 exposure draft, *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*. In particular, the Professional Ethics Executive Committee has adopted revisions of Interpretation 101-3 under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), to address the various types of other services that a member may perform for an attest client in today's practice environment and the impact of such services on the member's independence. The proposal sets forth general principles that the member should consider in evaluating the effect on independence of performing a service, and provides examples of general activities that would be considered to impair inde-

pendence. Specifically, the proposed revision to Interpretation 101-3 sets forth specific examples of when independence is and is not impaired when performing various benefit plan administration services. This interpretation is scheduled to be published in the May 1999 *Journal of Accountancy*. The interpretation can also be found on the AICPA Web site at <http://www.aicpa.org>. It is important to point out that, for ERISA engagements, the DOL has separate independence standards, which may be more restrictive than those of the AICPA. See paragraph A.79 in appendix A of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* for a listing of the DOL's independence standards.

## AICPA Services

.60 For a complete listing of AICPA services see *Audit Risk Alert*—1998/99 [AAM section 8010] (product no. 022223).

## Related AICPA Publications

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- AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (product no. 012339)
- AICPA Practice Aid *Financial Statement Reporting and Disclosure Practices for Employee Benefit Plans* (Offering the same kind of powerful help AICPA's *Accounting Trends and Techniques* does, this comprehensive practice aid illustrates a wide range of employee benefit plan financial statement disclosures and auditor's reports for both full-scope and limited-scope audits.) (product no. 008725)
- *Checklists and Illustrative Financial Statements for*—
  - *Defined Benefit Pension Plans* (product no. 008720)
  - *Defined Contribution Pension Plans* (product no. 008735)
  - *Health and Welfare Benefit Plans* (product no. 008721)
- "A Wake-Up Call"—An Employee Benefit Plan Audit Video (product no. 013800)

## National Conference

.62 Each spring the AICPA sponsors a National Conference on Employee Benefit Plans that is specifically designed to update auditors, plan administrators, and industry or plan sponsors on various topics including recent and proposed employee benefit plan legislative and regulatory issues, and significant accounting, auditing, and tax developments. The 2000 National Conference on Employee Benefit Plans will be held May 7-10, 2000, at the Hilton Walt Disney World, Orlando, Florida. Information on the conference may be obtained by calling the AICPA Conferences Division at (201) 938-3556.

## Continuing Professional Education

.63 The AICPA offers the following self-study courses (also available in group study form):

- *Audits of Employee Benefit Plans*
- *Audits of 401(k) Plans*

For group study courses, visit the AICPA Web site, at <http://www.aicpa.org/store/csearch.htm>, for a current schedule of where these courses are offered, or call your state society for complete details. Registration for all group study courses is done through your state CPA society.

## Order Information

.64 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066. Copies of FASB publications

referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

## Accounting and Auditing Technical Hotline and Ethics Hotline

.65 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. 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. To reach either hotline, call (888) 777-7077.

## World Wide Web Site

.66 The AICPA has 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. The Web site includes *In Our Opinion*, the newsletter of the AICPA Audit and Attest Standards Team. The newsletter provides valuable and timely information on technical activities and developments in auditing and attestation standard setting.

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.67 This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments—1998*.

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.68 The AICPA is currently offering a new CD-ROM product, entitled *reSource: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to the following AICPA Professional Literature products in a Windows format: *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set which includes all twenty-five Guides and the related Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need, and includes hypertext links to references within and between all products. To order any publications included on the CD-ROM, call (888) 777-7077.

.69 Practitioners Publishing Company (PPC) and the AICPA are currently offering publications issued by PPC, the AICPA, and the FASB on one CD-ROM disk, entitled *The Accounting and Auditing Library*. The FASB publications include *Original Pronouncements*, *Current Text*, *Emerging Issues Task Force Abstracts*, and *FASB Implementation Guides*; and the AICPA publications include *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides*, and *Peer Review Program Manual*. 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 (888) 777-7077.

.70 The Audit Risk Alert *Employee Benefit Plans Industry Developments* is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may email them to [ldelahanty@aicpa.org](mailto:ldelahanty@aicpa.org) or write to:

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# **Information Sources**

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Organization	General Information	Fax Services	Web Site Address
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	<a href="http://www.aicpa.org">http://www.aicpa.org</a>
Financial Accounting Standards Board	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	24 Hour Fax-on-Demand (203) 847-0700, menu item 14	<a href="http://www.fasb.org">http://www.fasb.org</a>
Department of Labor: Pension and Welfare Benefits Administration: Office of the Chief Accountant: Division of Accounting Services Division of Reporting Compliance Office of Regulations and Interpretations	(202) 219-8818 ERISA related accounting and auditing questions (202) 219-8794 Form 5500 preparation and filing requirements (202) 219-8770 (202) 219-7461		<a href="http://www.dol.gov/dol/pwba">http://www.dol.gov/dol/pwba</a>

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## Appendix A

### IRS Limits on Benefits and Compensation

	<u>1999</u>	<u>1998</u>	<u>1997</u>
<b>Defined Benefit</b>			
Maximum Annual Pension	\$130,000	\$130,000	\$125,000
<b>Defined Contribution</b>			
Maximum Annual Addition	\$ 30,000	\$ 30,000	\$ 30,000
<b>401(k) Plan</b>			
Maximum Elective Deferral	\$ 10,000	\$ 10,000	\$ 9,500
<b>403(b) Plan</b>			
Maximum Elective Deferral	\$ 10,000	\$ 10,000	\$ 9,500
<b>457 Plans</b>	\$ 8,000	\$ 8,000	\$ 7,500
<b>SIMPLE Plans</b>	\$ 6,000	\$ 6,000	\$ 6,000
<b>Qualified Plans</b>			
Maximum Compensation Limits	\$160,000	\$160,000	\$160,000
Highly Compensated Limits	\$ 80,000	\$ 80,000	\$ 80,000
Officer Limits (Key Employee)	\$ 65,000	\$ 65,000	\$ 62,500
FICA Taxable Wage Base	\$ 72,600	\$ 68,400	\$ 65,400
Employer and Employee Social Security Tax	6.20%	6.20%	6.20%



## Appendix B

### Sample Fiduciary Questions Regarding the Year 2000 Problem\*

The guidance issued to PWBA's field offices states that Year 2000 reviews will be conducted in all new and ongoing civil investigations. The attached list of sample fiduciary questions was provided to the field offices to assist the staff in the initial stages of conducting those reviews. In addition, the guidance provides that a Y2K warning will be issued in those cases where a determination is made that a plan fiduciary has failed to take appropriate measures to protect the interests of the plan and its participants and beneficiaries from the potential harm posed by the Year 2000 problem. The issuance of a warning is intended to place the plan fiduciary on notice of his or her obligation and to encourage voluntary compliance in addressing the Year 2000 issue. Regardless of whether a warning is received by an individual fiduciary, however, in those cases where plan fiduciaries fail to act prudently in performing their plan duties and plan participants and beneficiaries are adversely affected, appropriate enforcement action may be pursued.

#### *A. Plan's Internal Computer Operations*

1. Provide the name, position title, and telephone number of the person in your organization responsible for addressing the Year 2000 compliance of the plan's computer system.
2. If applicable, provide the name and telephone number of the person or entity hired to address the Year 2000 compliance of the plan's computer system. Provide a copy of the service contract.
3. If applicable, describe how the plan's Year 2000 service provider was selected and what information was reviewed in the course of the selection process.
4. What stages have been completed in addressing the Year 2000 problem (e.g., inventory development, assessment, remedial action, testing, contingency planning)?
5. If applicable, provide a copy of the strategy or planning document addressing how Year 2000 compliance will be ensured with respect to plan operations.
6. Has an inventory of plan-related computer information systems been developed for purposes of assessing Year 2000 compliance? Please provide a copy.
7. Has a Year 2000 compliance assessment been conducted? Please provide a copy.
8. What information has been reviewed by the plan fiduciaries regarding the plan's Year 2000 compliance?
9. What corrective measures have been identified to date? What remedial action, if any, has been taken? By whom? How much did it cost?
10. Who determined the remedial actions to be taken by the plan? What information provided the basis for the decision?
11. Has the plan been "certified" as Year 2000 compliant? If so, please explain and provide a copy of the certification.
12. Has a testing schedule been devised for the plan's computer systems? Who will perform the test?
13. Has a contingency plan been devised in the event critical computer operations are disrupted? If so, provide a copy.

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\* These sample questions were issued by the U.S. Department of Labor Pension and Welfare Benefits Administration (PWBA) to help the employee benefit industry understand these issues.

14. What information has been provided, or will be provided, to plan participants regarding the Year 2000 problem?
15. Who is responsible for paying the costs of addressing the Year 2000 problem?

***B. External Computer Operations of Plan Service Providers***

1. Has the plan compiled a list of service providers for purposes of determining Year 2000 compliance? Has the plan determined which of these providers renders essential or critical services? Provide a copy of the list.
2. Provide the name and telephone number of the plan fiduciary responsible for hiring the plan service providers.
3. Has the plan notified service providers of its expectations regarding Year 2000 compliance? If so, provide a copy of the notification.
4. Have contracts between the plan and its service providers been amended to address the plan's expectations regarding Year 2000 compliance? If so, provide copies of the contract amendments.
5. Has each plan service provider been contacted to determine their Year 2000 compliance? If so, please provide copies of the information requested and obtained from the service providers.
6. Has the plan fiduciary reviewed documentation from plan service providers regarding their Year 2000 compliance? If so, what information was reviewed and what action was taken by the plan fiduciary to ensure the plan's interests, and those of participants and beneficiaries, were protected?
7. Were any concerns expressed by the plan regarding the service provider's Year 2000 compliance? If so, what were those concerns and what actions were taken to address them?
8. What action has the plan taken to ensure that the remedial measures required to bring the service provider's computer system into Year 2000 compliance have been or will be implemented?
9. Has the plan determined that the service provider has scheduled or conducted testing of its computer systems for purposes of determining Year 2000 compliance?
10. Has the plan obtained documentation describing the service provider's contingency plan or the measures the service provider intends to implement in the event essential plan operations are disrupted due to a Year 2000 problem?

***C. Plan Sponsor's Computer System***

1. Has the plan obtained appropriate and timely information from the plan's sponsor regarding the Year 2000 compliance of its computer system?
2. Has the plan's fiduciary considered the potential impact of a Year 2000 problem in the plan sponsor's computer system in developing the plan's contingency plan?

***D. Investigations Focused on Financial Institutions (banks, insurance companies, brokers, investment managers, etc.)***

1. Identify the types of services provided to ERISA-covered employee benefit plans (e.g., trustee services, banking, brokerage, investment management, and record keeping). Describe the measures that have been taken to ensure that all such services have been evaluated for Year 2000 compliance.
2. If the financial institution is subject to regulation by a federal, state or other regulatory agency, what actions were taken to comply with that agency's requirements?
3. Has any governmental agency (state or federal) or other independent organization reviewed the company's computer operations for Year 2000 compliance? If so, identify the agency or agencies. If any report was produced and provided to the institution, please provide a copy.
4. What actions have been taken by the financial institution to ensure that its service providers and vendors are Year 2000 compliant (e.g., have investment managers checked on the Year 2000 compliance of their brokers)?

***E. Investment-Related Issues***

1. If the fiduciary makes investment decisions on behalf of the plan, what specific procedures are followed to determine that the investments are Year 2000 compliant?
2. If the plan offers investment options in connection with individually directed accounts under section 404(c) of ERISA, has the plan fiduciary taken appropriate steps to ensure that the investment options and related information systems are Year 2000 compliant?
3. If a plan has delegated investment responsibility or authority, in whole or in part, to an investment manager or other fiduciary, what procedures has the fiduciary implemented to monitor that fiduciary's investment decisions in connection with the Year 2000 problem?
4. In selecting, hiring, and retaining an investment adviser or manager, has the plan fiduciary obtained and reviewed appropriate information aimed at determining that investment decisions are made with consideration of Year 2000 compliance?

## Appendix C

### PWBA Year 2000 Questions and Answers\*

**Q.** *What is the Year 2000 problem and how does it affect employee benefit plans?*

- A.** The Year 2000 (Y2K) problem arises when a computer performing date-dependent computations or operations produces erroneous results because its system recognizes years only by the last two digits, causing a "00" entry to be read as the year "1900" rather than "2000." Because the computer systems, both hardware and software, produced in the past have commonly used the two-digit date designation, virtually all businesses are now faced with the enormous task of determining the extent to which their systems will be affected by the Year 2000 problem. Computer systems that are found to have a problem must be converted to a compliant format, i.e., and a format that reflects the correct date. As a general matter, the conversion process is recognized as both time-consuming and expensive.

Like most business operations, employee benefit plans rely on computers for most of their critical operations such as benefit calculations and payments. The Year 2000 problem may affect these operations in serious and potentially unpredictable ways. For example, assume a plan provides that an employee becomes eligible to participate in the plan at age 21 with one year of service. For a participant born in 1979 and employed beginning in December 1998, on January 1, 2000, the plan's computer system may miscalculate eligibility by showing the employee as *minus* 21 years of age and as having worked *minus* 99 years.

In addition, the Y2K problem is an issue for all of the businesses that provide critical services to employee benefit plans, such as banks, insurance companies, actuarial firms and investment management companies. The extent to which these businesses are affected by the Year 2000 problem could have serious consequences for their client plans.

**Q.** *What is a plan fiduciary's potential liability under the Employee Retirement Income Security Act (ERISA) with respect to the Year 2000 problem?*

- A.** As stated in the Department of Labor's February 9, 1998, press release, plan fiduciaries, such as plan administrators and trustees, are responsible for ensuring that plans and their participants and beneficiaries are protected. Such protection includes the establishment and implementation of a prudent procedure for ensuring that the plans' own computers, and, to the extent possible, those of the plans' service providers, are Year 2000 compliant. ERISA establishes comprehensive standards to govern fiduciary conduct. Among other things, a plan fiduciary must discharge his or her duties with respect to a plan solely in the interest of the plan's participants and beneficiaries. In addition, a plan fiduciary must discharge those duties with "the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." A fiduciary's failure to comply with ERISA's fiduciary responsibility requirements may result in personal liability for losses incurred by a plan or its participants and beneficiaries.

**Q.** *What constitutes a prudent procedure for ensuring Year 2000 compliance?*

- A.** Because the Year 2000 problem could have a substantial impact on plan investments, benefit payments and other essential plan operations, plan fiduciaries are responsible for establishing and implementing a strategy to evaluate and ensure Year 2000 compliance. Because of the complex and technological nature of this problem, however, plan fiduciaries may choose to hire outside consultants and experts to inventory, review, assess, convert and test the computer systems relating to the plan. The plan fiduciary's selection of those service providers is subject to the same fiduciary considerations as the selection of other plan service providers.

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\* Written and produced by the Pension and Welfare Benefits Administration, July 1998.

In addition to addressing the Year 2000 problem as it relates to computer systems under their control, plan fiduciaries have an obligation to determine whether the plan's critical operations will be endangered by the computer systems of unrelated service providers, such as third party administrators. In this regard, plan fiduciaries have an obligation to obtain information sufficient to evaluate each service provider's Year 2000 compliance and to monitor that compliance to ensure the plan's interests are protected.

Because of the pervasive nature of the Year 2000 problem, it may not be possible to prevent a disruption of computer operations. In recognition of that possibility, a plan fiduciary must determine how best to protect the plan and its participants and beneficiaries through the establishment of a contingency plan that will be implemented in the event the plan's essential operations are affected.

*Q. To what extent are plan fiduciaries responsible for Year 2000 problems that are caused by unrelated plan service providers?*

A. Plan fiduciaries are responsible for obtaining in a timely fashion appropriate information to evaluate the Year 2000 compliance of all of the plan's service providers and determining what action is appropriate to ensure that the interests of the plan and its participants and beneficiaries are protected. In addition, when selecting service providers, plan fiduciaries should include Year 2000 compliance as another factor to be considered. Finally, the plan fiduciary is responsible for monitoring the service provider's operations to ensure ongoing compliance and protection of the plan's interests.

*Q. Can the plan be charged for the costs associated with the Year 2000 problem?*

A. ERISA provides that reasonable expenses relating to the administration of an employee benefit plan may be charged to the plan. Also, the plan document should identify which costs may be charged to the plan. The issue of whether the cost of ameliorating the Year 2000 problem of a specific plan may be passed through depends on the terms of the plan document and whether the cost constitutes a reasonable administrative expense related to the plan.

For example, Company Y is a manufacturer and offers its employees a 401(k) plan through payroll deductions. Y has determined that its computerized payroll system is not Year 2000 compliant and large portions of its complex software system must be converted. As a general matter, Y is responsible for the costs of achieving Year 2000 compliance for its corporate payroll system. However, because the plan document permits charging the plan reasonable administrative fees, that portion of the cost relating directly to the plan's administration may be charged to the plan.

*Q. Is the Department planning to implement an enforcement initiative with respect to the Year 2000 problem?*

A. The Department's Pension and Welfare Benefits Administration (PWBA) investigators have already begun addressing the Year 2000 problem in the course of new and ongoing investigations. In those cases where plan fiduciaries have failed to act prudently in performing their plan duties and plan participants and beneficiaries have been adversely affected, appropriate enforcement action will be determined and pursued.

*Q. What should a plan administrator disclose about the plan's year 2000 activities to participants and beneficiaries?*

A. The Department strongly encourages plan administrators to disclose to their participants and beneficiaries the extent of the plan's Y2K preparedness. The administrator is encouraged to inform participants and beneficiaries as to the steps being taken to ensure the Y2K issue does not interrupt the operation of the plan or participants' and beneficiaries' access to their individual accounts.

Administrators are recommended to inform their participants and beneficiaries about:

- The plan's current level of readiness
- The strategy for bringing the plan's systems into Y2K compliance
- A timetable for when the critical systems will become Y2K compliant

- The level of compliance for service provider companies
- Possible effect on the participants and their beneficiaries should the plan become impaired in any way due to Y2K problems
- Any contingency, or backup, plans that have been devised in the event the plan is not Y2K compliant in time.

**Q.** *Are plan auditors, as part of their current engagements, required to detect potential record keeping problems associated with the year 2000?*

**A.** No. It is the plan administrator's responsibility for assessing and remedying any problems associated with the Y2K problem. Under generally accepted auditing standards (GAAS), the auditor does not have a responsibility to determine the effects of the Y2K issue on operational matters that do not affect the plan's ability to prepare financial statements for other than the year being audited.

SAS No. 83, *Establishing an Understanding With the Client*, requires auditors to obtain an understanding with the client regarding the services to be performed. This understanding is usually documented in an engagement letter addressed to the plan administrator and signed by the auditor. The Department of Labor encourages plan administrators to have language in engagement letters in order to clarify the auditor's responsibilities regarding the Y2K issue. This should minimize any confusion surrounding the auditor's duties and responsibilities. Engagement letters also should clarify how auditors intend to exercise their discretion to communicate matters that come to their attention relating to the Y2K issue in management letters or otherwise.

**Q.** *What information will be disclosed to the plan administrator by the plan's auditor relative to the Y2K problem?*

**A.** In general, the auditor is only obligated to list current system failures as reportable conditions and is not obligated to forecast future system failures. Therefore, the plan administrator cannot rely upon the plan's auditor to comment on potential record keeping problems regarding the Y2K issue that may arise in the future. Plan auditors are extremely cautious about being associated with any assertions that their clients' systems are Year 2000 compliant. The plan auditor's responsibility is limited to planning and performing an audit with the goal of obtaining reasonable assurance about whether the financial statements are free of material misstatement. The auditor is also responsible for reporting significant problems to the plan's management if such problems exist during the period being audited. The auditor's focus is on the current period, not future periods. Therefore, even in the event of an auditor becoming aware that in some period after the period being audited, the Y2K issue could adversely affect the plan's ability to process financial information, this potential future problem does not constitute a reportable condition in the current year.

**Q.** *What assurances will the Reports on the Processing of Transactions by Service Organizations (commonly referred to as SAS No. 70 reports) provide to plan administrators and their auditors regarding the Y2K issue?*

**A.** None. The Reports on the Processing of Transactions by Service Organizations (SAS No. 70 reports) are typically prepared by a service organization's independent auditors. These reports can provide a level of assurance to plan administrators and auditors regarding the system of internal controls in place at the service organization. Because these reports deal with a historical perspective, they do not provide assurances for prospective periods regarding deficiencies, which may affect those future periods (such as the Y2K issue). Accordingly, plan administrators and auditors should not expect the Reports on the Processing of Transactions by Service Organizations to provide any assurance on the organization's Y2K compliance.

**Q.** *Whom should I call if I have questions about how to address the Year 2000 problem?*

**A.** The Department of Labor is not in a position to provide guidance regarding the technical issue of how to resolve the Y2K problem. However, a large amount of information on the topic is available through the Internet. Some useful Websites include:

- **Federal Financial Institutions Examination Council (FFIEC)**—[www.ffiec.gov](http://www.ffiec.gov)—which provides a list of resources (bank association Websites and documents) useful to federally supervised financial institutions as well as trade groups, vendors and companies providing services to institutions.
- **American Institute of Certified Public Accountants (AICPA)**—[www.aicpa.org](http://www.aicpa.org)—which also has established hyperlinks to many private-sector and governmental Websites where helpful resources are identified.
- **The Small Business Administration (SBA)**—[www.sba.gov/y2k/](http://www.sba.gov/y2k/)—which offers specific assistance to the small business owner on the Y2K problem.
- **Office of the Comptroller of the Currency (OCC)**—[www.occ.ustreas.gov](http://www.occ.ustreas.gov)—which regulates and supervises national banks to ensure a safe, sound and competitive national banking system.
- **General Accounting Office (GAO)**—[www.gao.gov](http://www.gao.gov)—which even includes an auditor's checklist for the computer crisis.
- **Securities and Exchange Commission (SEC)**—[www.sec.gov](http://www.sec.gov)—which is responsible for administering the federal securities laws designed to protect investors in securities markets that operate fairly and ensure that investors have access to disclosure of all material information concerning publicly traded securities.
- **Information Technology Association of America (ITAA)**—[www.itaa.org/year2000.htm](http://www.itaa.org/year2000.htm)—which is a trade association representing the interests of the information technology industry.
- **General Services Administration (GSA)**—[www.itpolicy.gsa.gov/mks/yr2000/y2khome.htm](http://www.itpolicy.gsa.gov/mks/yr2000/y2khome.htm)—which contains information about planning, testing and contingency policy and also links to hundreds of private and public sites that offer advice and examples. (The Pension and Welfare Benefits Administration, while providing a direct linkage to these resources, neither guarantees or assumes responsibility for the information provided by these Websites.)

**Q.** *Whom should I call if I have questions about my potential fiduciary liability?*

**A.** If you have questions regarding your potential fiduciary liability, you may contact the Pension and Welfare Benefits Administration's Regional or District Office nearest you. A list of the agency's field offices follows:

- Atlanta Regional Office: (404) 562-2156
- Boston Regional Office: (617) 565-9600
- Chicago Regional Office: (312) 353-0900
- Cincinnati Regional Office: (606) 578-4680
- Dallas Regional Office: (214) 767-6831
- Detroit District Office: (313) 226-7450
- Kansas City Regional Office: (816) 426-5131
- Los Angeles Regional Office: (626) 583-7862
- Miami District Office: (954) 424-4022
- New York Regional Office: (212) 399-5191
- Philadelphia Regional Office: (215) 596-1134
- San Francisco Regional Office: (415) 975-4600

- St. Louis District Office: (314) 539-2693
  - Seattle District Office: (206) 553-4244
  - Washington, D.C. District Office: (202) 254-7013
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# AAM Section 8070

## *State and Local Governmental Developments—1998*

### In This Year's Alert . . .

- What is the economic outlook for state and local governments in 1998?
- Has the additional guidance needed to implement the Single Audit Act Amendments of 1996 been issued yet?
- Are there going to be any upcoming revisions to *Government Auditing Standards*?
- Have there been any IRS developments that auditors of state and local governments should be aware of?
- During the past few years, the SEC has ordered several large local governments to cease and desist certain financial reporting practices with regard to municipal bond issuances. What is the auditor's responsibility with respect to a government's official statement?
- Do governmental entities need to be concerned with the Taxpayer Relief Act of 1997?
- How will the new SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, assist auditors in performing audits of federal awards?
- How will the arrival of the year 2000 affect a government's accounting and financial information systems? What issues need to be addressed this year?
- What are the auditor's responsibilities when using the work of an actuary?
- What is the significance of an indemnification clause in an engagement letter? Should an auditor indemnify a client?
- What GASB Statements become effective during the next year?
- What other GASB Statements have been issued recently?

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### Industry and Economic Developments

#### *What is the economic outlook for state and local governments in 1998?*

.01 The extraordinary expansion of the U.S. economy over the past several years has resulted in a flood of tax revenue to state and local governments. The overall financial picture for many governments is better than it has been in a decade. Total state tax revenue rose 6.2 percent in 1997, up from 5.4 percent growth in 1996, according to the Center for Study of the States. Local governments have experienced similar growth. These increases in revenues are largely related to an unexpected spurt in personal and corporate income tax payments. A rise in sales taxes also contributed to the increases.

.02 As a result of this growth, many governments began 1998 in an unusually strong financial position and are now facing the pleasant task of deciding what to do with budget surpluses. According to a recent

report from the National Conference of State Legislatures, thirty-four states and many local governments passed tax cuts in 1997 in response to the increased collections, although many of the reductions were relatively small. Other state and local governments directed the extra revenue into reserves to serve as a buffer against potential future economic slumps. Some directed the funds to increased spending, and still others used the funds to pay off debts.

.03 These trends are likely to continue in 1998. According to the Center for the Study of the States, the temptation to cut taxes will likely continue to be attractive for many states in a year when almost three-fourths of governors and four-fifths of all legislative seats will be up for election. However, tax cuts will most likely be small, amid forecasts of slower economic growth in the future. Other key issues to be addressed by governments in 1998 will be funding for K-12 education, for corrections programs, and for transportation.

.04 Although state and local officials were concerned in 1997 about the impact of federal tax changes, the Taxpayer Relief Act of 1997 (Public Law 105-34) will have only a minor effect. For example, the capital gains rate reductions, the new federal child tax credit, and the education incentives included in the Act will not have a flow-through effect to states that base their state income taxes on either federal taxable or adjusted gross income. Likewise, the revenue-producing provisions in the Act generally will not have an impact. However, state and local governments may enjoy an unexpectedly large jump in capital gains tax revenues later in 1998 if investors rush to cash in on the new, lower federal rates.

.05 With all the recent glowing financial news, several items are on the radar screen of many state and local governments officials and will be watched closely. They are welfare reform, state and local taxation of electronic commerce, changes in the electric power industry, and other local government issues.

## **Welfare Reform**

.06 Welfare reform continues to be an area that could result in significant financial repercussions for some states. In the wake of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (Public Law 104-193), state and local governments are addressing a wide range of issues to implement sweeping changes in services to poor families and children. The law eliminated the automatic entitlement to welfare benefits for mothers and children who qualify. Instead, beginning in October 1996, states gained broad authority over their own welfare programs, and the form of federal funding was changed to block grants. The legislation also established a threshold level for the amount of state funding that is required. Although the law provides states with more flexibility to design and administer assistance programs that meet their own unique needs, they are now required to use federal funding to meet certain targets. Primary among these are work participation rates. States are eligible for a bonus for exceptional performance. However, if states do not meet these targets, the amount of state funding that is required could increase.

.07 Under the act, state and local governments are free to contract out a wider range of services than ever before. Some states have already turned to private companies to handle large portions of welfare programs or to take on lesser roles, such as redesigning computer systems for welfare programs. Others are in the process of considering some level of welfare privatization, including determination of eligibility, subject to federal approval. This new flexibility raises a number of issues for governments from the loss of public-sector jobs to monitoring the quality of work provided by the contractor. These privatizing activities could result in deep structural changes for many state and local governments. Auditors should consider the effect of these changes on their consideration of internal control.

## **State and Local Taxation of Electronic Commerce**

.08 The use of the Internet is exploding, and a number of difficult tax issues continue to arise. The debate centers on how, and whether, to subject Internet commerce transactions to state and local sales taxes. According to a recent report issued by the U.S. Department of Commerce, online sales are expected to grow from the current \$3.2 billion to \$300 billion by the year 2002. This growth is predicted to have a negative im-

pact on state and local sales and service tax revenues as more individuals begin making purchases over the Internet instead of going to the corner store. The Clinton administration has shown little support for additional taxes on Internet transactions. Further, bills have been introduced in both the U.S. House of Representatives and the U.S. Senate that would provide for a national moratorium on any new state and local taxation of the Internet. State and local governments will continue to focus attention on this area as they try to develop an acceptable model for taxing electronic commerce.

### Changes in the Electric Power Industry

.09 The last of the regulated utilities, electric power, also poses tax problems as states consider letting customers choose among power suppliers. This concept is known as retail wheeling, retail competition, or customer choice. By the end of 1998, consumers in several states should be able to choose their electric supplier. Other state and local governments are in the process of analyzing the potential advantages and disadvantages of customer choice. It will be important for governments to look at the possible impact of deregulation on their budgets and, when necessary, make changes to the tax laws. This is because customer choice will likely lead to competition in the industry, which would allow consumers to bargain for their rates. Many governments rely heavily on utility taxes or charges that are based on a percentage of sales (for example, gross receipts taxes, municipal utility taxes, and sales taxes). As power prices are forced downward by competition and customer bases begin to fluctuate, state and local governments face the possibility of significantly lower revenue. Another issue relates to property taxes. Many utilities are in the process of writing down the market value of uneconomic utility assets. This will affect property valuations, and ultimately property taxes may decrease.

.10 There are also issues for governments that provide electric services directly to their citizens. Some of those governments have counted on the income from the electric service to enable them to reduce taxes or provide other public services. If local customers decide to choose another utility, there will be revenue implications for the government. Municipal electric utilities will have to work to develop competitive rates or risk losing customers. Also, municipal electric utilities have, in some cases, entered into take-or-pay contracts, whereby they are obligated to pay fixed amounts of money for the right to receive power. With the advent of deregulation, power prices are falling and the locked-in prices for future power purchases will likely be higher than the market, resulting in a stranded investment. These stranded investments may result in significant future commitments on the part of the utility. Auditors should consider whether these future commitments have been appropriately disclosed.

### Other Local Government Issues

.11 While many governments are facing the pleasant task of deciding what to do with budget surpluses, there are some local governments that are facing issues that could have serious financial consequences. One relates to meeting the challenges associated with increased school enrollments. In some cases, state aid to local governments has been reduced, causing local governments to search for new sources of revenue. An increase in local tax appeals is also a concern to local governments. Last, large cities continue to face the need to replace aging infrastructure.

#### Executive Summary—Industry and Economic Developments

- The overall financial picture for many governments is better than it has been in a decade.
- Many governments are now facing the pleasant task of deciding what to do with budget surpluses.
- Key issues to be addressed by governments in 1998 will be tax cuts and funding for K-12 education, corrections programs, and transportation.
- Government officials will closely watch welfare reform, state and local taxation of electronic commerce, changes in the electric power industry, and other local government issues due to the potential future financial implications.

## Regulatory, Legislative, and Other Developments

### Single Audit Guidance Issued

#### *Has the additional guidance needed to implement the Single Audit Act Amendments of 1996 been issued yet?*

.12 Since the Single Audit Act Amendments of 1996<sup>1</sup> became law in July 1996 (Public Law 104-156), auditors have been anxiously awaiting the additional guidance needed to assist in the law's implementation. At long last, most of that final guidance has been issued. During the past year the U.S. Office of Management and Budget (OMB) issued a final revision to OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133) (*Federal Register*; June 30, 1997), the related data collection form, and the provisional OMB Circular A-133 *Compliance Supplement*. The sections below summarize these key pieces of guidance. Also, in March 1998, the AICPA issued Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*. This SOP is discussed in greater detail in the section of this Audit Risk Alert entitled "Audit Issues and Developments." The AICPA has also prepared an unofficial question-and-answer document on commonly asked single audit matters. It can be retrieved from the AICPA Web Site at <http://www.aicpa.org/belt/a133main.htm> or from the AICPA Fax Hotline at (201) 938-3787 (document number 316). Auditors performing audits of federal awards should carefully review the new guidance to ensure that the appropriate work is completed in an audit of federal awards.

.13 *Circular A-133.* The OMB issued a final revision to Circular A-133 in the June 30, 1997, *Federal Register* (62 FR 35278).<sup>2</sup> In the same *Federal Register* notice, the OMB rescinded Circular A-128, *Audits of State and Local Governments*, which was the regulation that governed audits of federal awards for states and local governments, and superseded the prior Circular A-133, *Audits of Institutions of Higher Education and Other Non-Profit Institutions*, issued April 22, 1996. The final revision incorporates changes necessary to comply with the Single Audit Act Amendments of 1996, including the expansion of the scope of the Circular to cover states and local governments. The revised Circular was effective for audits of fiscal years beginning after June 30, 1996.

.14 Circular A-133 establishes audit requirements that apply to not-for-profit organizations (including hospitals and colleges and universities), states (including Indian tribal governments), and local governments. Some of the more significant 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.
- Major program coverage is required to be a minimum of 50 percent (or 25 percent for low-risk auditees) of federal awards expended.
- The definition of *nonprofit organization* is revised to include nonprofit hospitals.
- 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.

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<sup>1</sup> A copy of the 1996 Amendments is 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.ignet.gov> under the listing "Single Audit." Also, the full text of the 1996 Amendments is included in appendix A of SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

<sup>2</sup> A copy of Circular A-133 can be obtained from the June 30, 1997, *Federal Register*; the OMB's fax information hotline at (202) 395-3068, document number 1133; the OMB home page at [www.whitehouse.gov/WH/EOP/OMB/Grants](http://www.whitehouse.gov/WH/EOP/OMB/Grants); or by writing or calling the Office of Administration, Publications Office, Room 2200, New Executive Office Building, Washington, DC 20503; (202) 395-7332. Also, the full text of the Circular is included in appendix B of SOP 98-3.

- 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 report submission process is also streamlined, including incorporating a data collection form that must be completed and signed by both the auditee and the auditor.
- Guidance is included for conducting program-specific audits.

.15 The OMB instructed federal agencies to adopt Circular A-133 in codified regulations so the Circular would apply to audits of fiscal years beginning after June 30, 1996. In an interim final rule issued in the August 29, 1997, *Federal Register* (62 FR 45937), twenty-seven federal agencies adopted the provisions of Circular A-133. The U.S. Department of Housing and Urban Development (HUD) adopted the provisions of Circular A-133 in a separate interim rule that was published in the November 18, 1997, *Federal Register* (62 FR 61616). See table 1 for a summary of the agencies that have adopted Circular A-133 and for a cite to their specific regulations. Whereas most federal agencies amended both their Grants Management Common Rule and their codification of Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*, to adopt Circular A-133 verbatim, some agencies added additional audit requirements (agencies that made changes are noted on table 1 with an asterisk). Auditors should refer to those agency's regulations or the *Federal Register* notices to ascertain the additional requirements.

Table 1

## Federal Agencies Adopting Circular A-133

<i>Federal Agency</i>	<i>Location of Regulation</i>
Agency for International Development	22 CFR Part 226
Department of Agriculture	7 CFR Parts 3016 and 3019
Department of Commerce	15 CFR Part 24
Corporation for National and Community Service	45 CFR Parts 2541 and 2543
Department of Defense	32 CFR Part 33
Department of Education	34 CFR Parts 74 and 80
Department of Energy	10 CFR Part 600
Environmental Protection Agency	40 CFR Parts 30 and 31
Federal Emergency Management Agency	44 CFR Part 13
Federal Mediation and Conciliation Service	29 CFR Part 1470
General Services Administration	41 CFR Parts 105-71 and 105-72
Department of Health and Human Services	45 CFR Parts 74 and 92*
Department of Housing and Urban Development	24 CFR Part 84*
United States Information Agency	22 CFR Part 518
Department of the Interior	43 CFR Part 12

<i>Federal Agency</i>	<i>Location of Regulation</i>
Institute of Museum and Library Services	45 CFR Part 1183
Department of Justice	28 CFR Parts 66 and 70*
Department of Labor	29 CFR Parts 95 and 97
National Aeronautics and Space Administration	14 CFR Parts 1260 and 1273
National Archives and Records Administration	36 CFR Parts 1207 and 1210
National Endowment for the Arts	45 CFR Part 1157
National Endowment for the Humanities	45 CFR Part 1174
National Science Foundation	45 CFR Part 602
Office of National Drug Control Policy	21 CFR Part 1403
Small Business Administration	13 CFR Part 143
Department of State	22 CFR Parts 135 and 145
Department of Transportation	49 CFR Parts 18 and 19
Department of Veterans Affairs	38 CFR Part 43

\* These agencies added additional audit requirements when they adopted Circular A-133.

The agencies listed in table 1 represent most of the major federal agencies that provide federal awards. In the event that other agencies provide federal awards and have not adopted Circular A-133, auditors should follow the revised Circular.

**.16 Compliance Supplement.** The OMB also issued a provisional *OMB Circular A-133 Compliance Supplement* in June 1997, which was effective for audits of fiscal years beginning after June 30, 1996.<sup>3</sup> It replaces 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).

**.17** The *Compliance Supplement* is based on the requirements of the Single Audit Act Amendments of 1996 and the revised Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. It serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act Amendments of 1996 and Circular A-133. For the approximately twenty-five programs included in the provisional *Compliance Supplement*, information is included to assist auditors in understanding the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements. Part 7 of the *Compliance Supplement* was added to provide guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included in the *Compliance Supplement*.

**.18** Other significant changes to the revised *Compliance Supplement* include the following:

<sup>3</sup> A copy of the *Compliance Supplement* (Provisional) issued in June 1997 is available on OMB's home page at <http://www.whitehouse.gov/WH/EOP/OMB/Grants> and the Office of Inspector General home page at <http://www.ignet.gov>. The 1998 *Compliance Supplement* will be available from the Government Printing Office (stock number 41-001-00507-2) and on OMB's home page.

- 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 fourteen types of compliance requirements, all of which are covered by the auditor's opinion on compliance.
- 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*.
- 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.
- An appendix that provides federal agency contacts for Circular A-133 audits, including addresses, phone number and email information.

.19 The *Compliance Supplement* was issued in provisional form so it could be used as part of the first audits to be conducted under the revised Circular and so that interested parties could comment on it. Upon its issuance, the OMB made a commitment to continue working to expand the *Compliance Supplement* to include additional federal programs. As a result, the OMB anticipates issuing the 1998 version of the *Compliance Supplement* in mid 1998. This revision will make slight changes to the existing provisional *Compliance Supplement* based on public comments received and will also add approximately fifty additional federal programs. When issued, a notice of availability will be published in the *Federal Register* that will include guidance on how to obtain a copy of the revised Supplement. The OMB home page (<http://www.whitehouse.gov/WH/EOP/OMB/Grants>) will also include an electronic copy of the revised Supplement and information on how to obtain a printed copy. Auditors should also watch the *CPA Letter* and the AICPA home page ([www.aicpa.org](http://www.aicpa.org)) for updates on the status of the *Compliance Supplement*.

.20 *Data Collection Form*. Among the major changes in single audit policy has been the advent of the data collection form.<sup>4</sup> The purpose of the form is to assist the federal government in accumulating information regarding the thousands of single audits that are performed. The information required to be included in the form represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards. Circular A-133 requires the auditee to complete and sign certain sections of the form that states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit.

.21 The auditor is also required to complete certain sections of the data collection form, including information on the auditor and information on the results of the financial statement audit and the audit of federal programs. The auditor is required to sign a statement in the form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package, and that the content of the form is limited to the data elements prescribed by the OMB. As part of completing the form, the auditor is asked to date it. The date that is entered by the auditor should be the date on which he or she completes and signs the form. The wording of the auditor's statement section of the form indicates that no additional procedures were performed since the

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<sup>4</sup> The data collection form and related instructions are available on the OMB's home page at [www.whitehouse.gov/WH/EOP/OMB/Grants](http://www.whitehouse.gov/WH/EOP/OMB/Grants). Auditors are not permitted to create their own electronic version of the form. Instead, the Federal Audit Clearinghouse (FAC) has developed the data collection form in various word processing packages (for example, Microsoft Word and WordPerfect). These electronic versions of the form are available from the FAC Web Site at <http://harvester.census.gov/sac>. A hard copy of the form and instructions can also be obtained from the FAC at (888) 222-9907. The form number is SF-SAC. The FAC is also currently working on a process for electronic submission. Auditors can follow developments on this project by periodically reviewing the FAC Web Site.

date of the audit reports. This wording alleviates the auditor from any subsequent-event responsibility for the timing of the completion of the form and the completion of the audit.

.22 It is very important for both the auditor and auditee to carefully follow the detailed instructions that accompany the form. The Federal Audit Clearinghouse (FAC) is the entity that is responsible for receiving report submissions and data collection forms and maintaining the database of completed audits. If auditors or auditees have any questions on the completion of the form, they should contact the FAC at (301) 457-1551. As of the date of this Audit Risk Alert, the FAC has reported that 95 percent of the forms received to date have included errors. Problems have also been noted with the reporting package submissions. When errors are noted by the FAC, an error message is sent to the auditee for resolution. The following information details some of the problems noted by the FAC and is included to help auditors and auditees avoid making similar errors.

- The data collection form is not part of the reporting package, although Circular A-133 requires that it be submitted along with the reporting package. Therefore, it should not be stapled to or bound with the reporting package. Further, the data collection form should not be sent in a mailing separate from the reporting package submission. A fax submission of the form will not be accepted.
- Auditees should not send reporting packages directly to federal agencies unless a copy is specifically requested by the federal agency. Under the new rules, auditees are required to submit one copy of the reporting package for the FAC to retain as an archival copy. A copy must also be submitted (to the FAC) for each federal agency where the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the federal agency provided directly or where the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the federal awarding agency provided directly. For example, consider an auditee that has four federal awards that were received directly from four federal agencies. Further, assume that the current-year single audit resulted in audit findings on two of the four federal awards and that the summary schedule of prior audit findings included the status of a prior-year finding related to a third federal award that had no current-year audit findings. In this example, the auditee would be required to submit four reporting packages to the FAC—one for the FAC to retain as an archival copy, two for the federal agencies that provided federal awards that had current-year findings associated with them, and one for the federal agency where the summary schedule of prior audit findings reported the status of a prior-year finding.
- The form asks auditors to identify the federal agencies that are required to receive a copy of the reporting package (part III, question 5). Only those federal agencies affected by audit findings (described in the bulleted item above) should be identified as needing to receive a copy of the reporting package. Some auditors have incorrectly answered this question by identifying every federal agency that provided funding to the auditee. Similarly, if no findings were required to be reported under section 510(a) of Circular A-133 (part III, question 4), and the summary schedule of prior audit findings does not report the status of any audit findings relating to federal awards, then the box “none” should be checked to indicate that no federal agencies are required to receive a copy of the reporting package in part III, question 5.
- A number of problems have also been noted with part III, question 7, on audit findings and questioned costs. Auditors should note that this section of the form must be completed in its entirety for every single audit, regardless of whether findings and questioned costs were noted. Also, section (b) of this question asks the auditor to identify the types of compliance requirements. Auditors should note that the only types of compliance requirements that should be listed are those requirements with audit findings associated with them. Some auditors have been incorrectly listing all requirements that apply to a particular program. If no findings were noted, the form indicates that the auditor should complete this section with the letter O.
- Only one federal agency should be identified as the cognizant or oversight agency for audit (part I, question 9). Further, it is not appropriate for a pass-through entity to be listed as the cognizant or oversight agency for audit.



- The form asks the auditor to identify the dollar threshold used to distinguish between type A and type B programs. The FAC has reported that a number of forms have erroneously indicated a threshold of less than \$300,000. This is incorrect, because the floor for the threshold is \$300,000. Some auditors have also mistakenly indicated two thresholds—one for type A and one for type B programs. Others have mistakenly indicated no value. In responding to this part of the form, the auditor should include the result of his or her analysis of step 1 in the risk-based approach (described in section 520(b) of Circular A-133). The dollar amount should always be \$300,000 or more.

It should also be noted that the Catalog of Federal Domestic Assistance (CFDA) number is a required field in part III, question 6, and an appropriate number must be included or the data collection form will be rejected. When a CFDA number is not available, the auditor should use another identifying number assigned by the federal awarding agency or pass-through entity. Individual programs within a cluster of programs should be listed separately on the form except for the research and development (R&D) cluster which may be listed either separately or at the federal agency and major subdivision within the federal agency level (for example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services). This option for R&D is both for the schedule of expenditures of federal awards and the data collection form. The same option is not required in both places (for example, it is acceptable to list R&D awards by individual award in the schedule and by federal agency and major subdivision in the form).

.23 Since no CFDA or other identifying number is available when listing R&D at the federal agency and major subdivision level in part III, question 6, the auditor should use the first two digits of the CFDA assigned to the awarding federal agency followed by a period and the letters RD to indicate R&D. For example, all major subdivisions within the Department of Health and Human Services would have the same number which would be 93.RD. Use the agency list in appendix B to this Audit Risk Alert to assign the 2-digit CFDA agency number.

.24 If a grant has no identifying number (for example, no CFDA or other identifying number is available from the federal awarding agency or pass-through entity), the auditor should use the first two digits of the CFDA assigned to the federal awarding agency (for example, 93 for the Department of Health and Human Services) to indicate the agency that provided the award when filling out part III, question 6. Use the agency list included in appendix B to this Audit Risk Alert to assign the 2-digit CFDA agency number.

#### Executive Summary—Single Audit Guidance Issued

- The OMB issued a final revision to Circular A-133 on June 30, 1997, which establishes audit requirements that apply to not-for-profit organizations, states, and local governments.
- Twenty-eight federal agencies have subsequently amended both their grants management common rule and their codification of Circular A-110 to adopt Circular A-133.
- The OMB issued a provisional *OMB Circular A-133 Compliance Supplement* in June 1997 and the 1998 *Compliance Supplement* is expected in mid 1998.
- A data collection form is now required, which includes a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards.
- The FAC has reported finding a number of problems with the data collection forms that have been submitted.
- Auditors performing audits of federal awards should carefully review the new guidance to ensure that the appropriate work is completed in an audit of federal awards.

#### Status of Interim Compliance Supplements for Housing Agencies and Authorities and Certain Department of Education Programs

.25 Last year's Audit Risk Alert reported that two federal agencies had 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. The following provides an updated status on the guidance.

**.26 Housing Authorities.** Guidance for audits of 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. For audits of PIH Authorities under Circular A-133, the agency program requirements (which would otherwise be listed in part 4 of the *Compliance Supplement*) are provided in the PIH Supplement. This supplement is currently available on the Internet at the HUD OIG home page (<http://www.hud.gov/oig/oigguide.html>) under the listing, "Audit Guides," or can be obtained by sending a fax to (202) 401-3963. The guidance contained in the Section 8 cluster in part 4 of the *Compliance Supplement* is intended for audits of entities other than Public and Indian Housing Authorities that administer or participate in Section 8 programs, including state housing agencies and non-profit multifamily housing projects.

**.27 U.S. Department of Education Programs.** In June 1996, the U.S. Department of Education published interim guidance that includes the agency program requirements 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 programs will be included in the 1998 *Compliance Supplement* and all references to the interim guidance in the *Compliance Supplement* will be deleted. Once this occurs, auditors should no longer refer to the interim guidance.

## Minor Revisions Made to Grants Management Circulars

**.28** In the August 29, 1997, *Federal Register* (62 FR 45934), the OMB revised OMB Circular A-102, *Grants and Cooperative Agreements with State and Local Governments*, Circular A-21, Circular A-87, Circular A-110, and Circular A-122. The purpose of these revisions is to provide a conditional exemption from the OMB's grants management requirements and a conditional class deviation from the agencies' Grants Management Common Rule for certain federal grant programs with statutorily authorized consolidated planning and consolidated administrative funding, which are identified by a federal agency and approved by the head of the executive department or establishment. The revisions were effective on September 29, 1997.

## Proposed Revisions to OMB Circular A-21

**.29** Auditors involved with audits of federal awards for governmental colleges and universities should be aware that the OMB issued proposed revisions to Circular A-21 in May 1998. The revisions were finalized at the time of the printing of this Audit Risk Alert and are expected to be published in the *Federal Register* in late May or early June. OMB will also post the recompiled circular on its home page (<http://www.whitehouse.gov/WH/EOP/OMB/Grants>).

**.30** The 1998 changes to Circular A-21 include establishing a review process for large research facilities, establishing a utility cost adjustment, clarifying the computation of use allowance and depreciation, and prescribing a standard indirect cost format.

## Potential Revisions to Government Auditing Standards

*Are there going to be any upcoming revisions to Government Auditing Standards?*

**.31** Auditors should be aware that the General Accounting Office (GAO) is expected to propose revisions to *Government Auditing Standards* (GAS; also known as the Yellow Book) in the upcoming year. The Advisory Council on Government Auditing Standards has been reconvened and is in the process of deliberating potential changes. One decision that has already been made by the Council is to change the process by which

it revises *Government Auditing Standards*. Rather than issuing a complete overhaul to *Government Auditing Standards* every five years, the Council will issue topic-specific revisions on an as-needed basis. Therefore, instead of completely reprinting *Government Auditing Standards* when a change is made, only the new or revised standard will be issued. Periodically, when a significant number of changes have been made, the GAO will reprint a new codification of its standards. Also, the GAO has decided to expand its product line relating to *Government Auditing Standards*. In the future, the GAO will likely issue implementation guidance on new or revised standards and also question and answer documents.

.32 Upon proposing revisions in the above areas, the Council will issue exposure drafts for public comment and feedback. These exposure drafts will be available on the GAO home page ([www.gao.gov](http://www.gao.gov)). The Council will consider comments received and advise the GAO on the Council's recommendation for a final standard. Auditors should be alert for potential changes in this area. Watch future issues of the *CPA Letter* and the *Journal of Accountancy* for status updates.

## Recent IRS Activities

*Have there been any IRS developments that auditors of state and local governments should be aware of?*

.33 *Internal Revenue Service Audits.* The Internal Revenue Service (IRS) continues to increase its enforcement activities regarding tax-exempt municipal bonds. The IRS has audited or is auditing several hundred targeted and randomly selected municipal bond issues for possible tax law violations. In completing its first batch of those audits, the IRS reported that problems were noted in a significant number of the cases. Many 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 random audit program is relatively new; it is being used by the IRS 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 declare the bonds taxable and to tax bondholders on their interest earnings.

.34 Yield burning continues to be an area of keen interest for the IRS. This is because the practice may be costing the agency billions of dollars in lost tax revenues. Yield burning occurs when municipalities pay inflated prices for government securities used in refinancing more expensive older debt. Typically, the proceeds of the new bonds are put into temporary escrow accounts. By law, those accounts cannot generate a higher rate of interest than the rate on the newly issued bonds. Paying inflated prices for the government securities reduces the yield, eliminating arbitrage. When yield burning occurs, securities firms generate illegitimate profits for themselves that would otherwise go to the U.S. Treasury. Yield burning may be done without the knowledge of the issuer by others involved in the transaction. Although the Securities and Exchange Commission (SEC) has recently begun investigating several Wall Street firms to determine whether they were involved in yield-burning activities, the governmental issuer is the one responsible under current tax laws, and the IRS is moving aggressively to recoup money. The IRS has reported that it is looking into several dozen cases and that it believes that there are hundreds more. Some governments are being pressured to settle with the IRS or risk losing the tax-free status of certain bond issues.

.35 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. However, many issuers have indicated that it is doubtful that they would use this remedy because they view the problems associated with yield burning as being related to the securities industry. Because of the IRS interest in yield burning, issuers should examine past advance refundings. Yield burning may have occurred if: (1) open market securities were used to fund an escrow (as opposed to State and Local Government Series Treasury securities), (2) the yield on the escrow is only slightly below the bond yield, and (3) the securities were not purchased using a legitimate bidding process. Auditors should consider suggesting that bond counsel be consulted in such cases.

.36 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 an error 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.

.37 *FICA Reporting.* Since the 1980s, significant changes affecting state and local government employers have been made to the Social Security Act and the IRC. These changes have greatly expanded the roles and responsibilities of state and local government employers with regard to Federal Insurance Contributions Act (FICA) reporting and Social Security and Medicare coverage. Legislation enacted in 1985 expanded FICA coverage on a mandatory basis to uncovered employees based on certain criteria (before that time it had been on a voluntary basis). Further, legislation enacted in 1990 mandated full FICA (Social Security and Medicare) coverage beginning July 1, 1991, for certain employees.

.38 Both the Social Security Administration (SSA) and the IRS are concerned that a sizable number of public employers may not be accurately reporting the Social Security coverage status of their employees. The lack of compliance in this area is thought to be due to the complexity of the law, complicated changes in the coverage provisions, and a diminished role of Social Security administrators. The problem that results from noncompliance by public employers is that the SSA is obligated to pay retroactive coverage and benefits even though the Social Security taxes may not have been paid into the trust funds. Auditors should be aware that state and local employers may be liable for past taxes that should have been paid to the trust fund. However, IRS personnel have stated that they are looking strongly at prospective settlement agreements in instances of noncompliance, because most state and local governments are funded through annual appropriations and often lack the funds to make immediate payment in the event of deficiencies.

.39 The IRS has developed a strategy to encourage compliance in this area. The first part of this strategy is education and outreach. The IRS is sending general information to all public employers on their responsibilities in this area and is contacting certain employers when the IRS is aware of specific noncompliance. As part of this outreach effort, the IRS has issued a 1997 edition of a Federal-State Reference Guide titled *Social Security Coverage and FICA Reporting by State and Local Government Employers*.<sup>5</sup> The guide provides state and local governments with a comprehensive source for FICA coverage and withholding rules. A second part of the IRS strategy is the performance of examinations. Although the IRS expects to bring most public employers into voluntary compliance, examinations may be used after outreach is unsuccessful in obtaining such voluntary compliance.

.40 *IRS Issues Rules for Electronic Fund Deposits.* In the July 14, 1997, *Federal Register* (62 FR 37490), the IRS issued rules providing guidance for the electronic depositing of federal withholding taxes, waivers of penalties, and procedures for enrolling in the Electronic Federal Tax Payment System (EFTPS). Those rules required state and local government employers with at least \$50,000 in employment taxes withheld in 1995 to begin filing electronically as of January 1, 1998, to avoid penalty. In a news release issued on March 31, 1998 (IR-98-28), the IRS extended the January deadline and stated that affected organizations now have until January 1, 1999, before the IRS will impose penalties. Additional information on the EFTPS can be obtained by contacting EFTPS Customer Service at (800) 555-4477 or (800) 945-8400.

.41 *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

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<sup>5</sup> To order a copy of this reference guide, contact the IRS at (800) 829-3676, request Publication 963, and specify the 1997 edition, or contact a Social Security administrator.

included exceeding the various contribution limits, noncompliance with distribution requirements, inadequate salary reduction agreements, and failure to offer universal availability of salary reduction programs (because of 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 to the employees. It should be noted that not only would an employee be subject to tax, but the governmental sponsor can be held liable for employees' unpaid tax and can be subjected to penalties for under-reporting wages. Auditors should be alert to potential liabilities and compliance problems in this area, especially because the IRS has confirmed that it will be auditing governmental entities.

.42 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 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, and can reduce an employer's risk of liability.

.43 *Classification of Employees Versus Independent Contractors.* In their efforts to reengineer and streamline operations, many governments 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 for state tax purposes. Auditors should be alert to such misclassifications by employers, which can result in compliance problems and potential tax liabilities.

.44 There have been three significant developments in this area during the last several years. 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 (CSP) 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 was originally scheduled to be open for two years, beginning March 5, 1996. However, the IRS has said that it is assembling a task force to contemplate extending the CSP beyond March 1998.

#### **Executive Summary—Recent IRS Activities**

- The IRS continues to audit tax-exempt municipal bond issues for possible tax law violations, including yield burning and other arbitrage-related problems.
- The SSA and the IRS are concerned about problems with state and local government reporting of FICA, Social Security, and Medicare coverage.
- The IRS issued new rules for the electronic depositing of federal withholding taxes, which are applicable to state and local governments.
- The IRS continues to closely monitor governments with Section 403(b) tax-sheltered annuities and those that use independent contractors.

## SEC Issues Cease-and-Desist Orders to Several Governments

*During the past few years, the SEC has ordered several large local governments to cease and desist certain financial reporting practices with regard to municipal bond issuances.*

*What is the auditor's responsibility with respect to a government's official statement?*

.45 Although Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933, and a mandated system of periodic reporting under the Securities Act of 1934, it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of those acts. Auditors that are involved with a governmental entity's issuance of an official statement should be aware that during the last several years, the SEC has ordered several large local governments to cease and desist certain financial reporting practices that it claimed violated the antifraud provisions. In one case, a government included prior-year financial statements in its official statement because the current-year statements were not yet available. However, the government's financial condition had materially declined since the prior-year statements were issued. In another case, a government did not include the prior-year financial statements in its official statement, claiming they were too old. Instead, only summary financial information for its current year-end was included (the audited financial statements for the current year were not yet available). Unfortunately, the summary information was found to be materially misstated. Although not required, some firms have begun to include a provision in the engagement letter requiring the government to obtain consent from the auditor before using the independent auditor's report in the official statement to avoid problems similar to those described above.

.46 Auditors are not required to participate in, or undertake, any procedures with respect to an official statement, except in certain situations. Auditors should refer to chapter 19, "Association With Financial Statements Included in Official Statements," of the Audit and Accounting Guide *Audits of State and Local Governmental Units* for a description of those situations and for guidance on the auditor's responsibilities with regard to a government's official statement.

## Effect of Taxpayer Relief Act of 1997 on Governmental Entities

*Do governmental entities need to be concerned with the Taxpayer Relief Act of 1997?*

.47 Although much of the press that was generated from the issuance of the Taxpayer Relief Act of 1997 focused on how it affected individuals and the private sector, there were several provisions that affect state and local governments. The provisions that auditors of state and local governments should be aware of largely relate to arbitrage on tax-exempt bonds and are described in the following list:

- Under prior law, governments were able to avoid arbitrage rebate on public purpose bonds if either (1) all bond proceeds were used for the specified purpose within six months, or (2) if all bond proceeds were used for the specified purpose within six months except for the lesser of \$100,000 or 5 percent of the proceeds and the remaining proceeds were spent within one year after the issuance. The new law repeals the \$100,000 limit on proceeds that can remain unspent after six months. Now, at least 95 percent of the bond proceeds must be spent for the specified purpose within six months after the issuance, and the remaining proceeds must be spent within one year after the issuance. This provision was effective for bonds issued after August 5, 1997.
- There was an increase in the small issuer arbitrage rebate exception. The legislation provides that up to \$5 million of bonds used to finance public school capital expenditures are excluded from the former small issuer limit of \$5 million. This effectively raises the small issuer rebate exception to \$10 million for certain issuers that use bond proceeds to finance the construction of public school facilities. This provision was effective for bonds issued after December 31, 1997.
- For bonds issued after August 5, 1997, the new law exempts earnings on construction bond issue proceeds invested in debt service funds from arbitrage rebate requirements if the available construction proceeds are spent as required over a twenty-four month period.

## Revisions to Passenger Facility Charge Audit Guide

.48 Auditors of public airports should be aware that the Federal Aviation Administration (FAA) is in the process of updating its audit guide for passenger facility charges (PFCs), titled *Passenger Facility Charge Audit Guide for Public Agencies*. PFCs are the \$1 to \$3 fee added to many airline passengers' airfare. The airlines collect these fees and submit them to the appropriate airports. The airports then use the PFCs on certain airport projects. The main purpose of the proposed revisions to the guide is to more closely align it with a similar guide used in audits of the airlines that collect PFCs and to update certain references in the guide for recent revisions to the Single Audit Act Amendments of 1996 and Circular A-133 (see the related discussion earlier in this Alert).

.49 Auditors engaged to audit PFC accounts are required, among other things, to report on the fairness and reasonableness of the airport's procedures for receiving, holding, and using PFC revenues. Auditors should note that PFCs are not considered to be federal awards as defined by Circular A-133. However, the audit is permitted to be performed as a separate audit or as part of an audit under the Single Audit Act (even though it is not a federal award). Under the latter option, the auditor should treat the PFC program as if it were a major program. However, the auditor should not include the PFC program when evaluating whether the percentage-of-coverage rule has been met. Further, the auditor should not include PFC program information on the data collection form.

## Audit Issues and Developments

### New Statement of Position on Auditing Federal Awards Issued

*How will the new SOP 98-3, Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards, assist auditors in performing audits of federal awards?*

.50 As a result of the numerous changes in the single audit arena (described in the section of this Audit Risk Alert titled "Regulatory, Legislative, and Other Developments"), the AICPA issued SOP 98-3, *Audits of States, Local Governments, and Not-For-Profit Organizations Receiving Federal Awards* (No. 014904).<sup>6</sup> The SOP, which was issued March 17, 1998, supersedes SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and Part VII, "Audits of Federal Financial Assistance," of the Audit and Accounting Guide *Audits of State and Local Governmental Units*. SOP 98-3 provides auditors of states, local governments, and not-for-profit organizations with guidance on the work performed and the reports issued for audits under the Single Audit Act Amendments of 1996 and Circular A-133. In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, SOP 98-3—

- Describes the auditor's responsibility for testing and reporting on the financial statements and the schedule of expenditures of federal awards.
- Discusses various planning and other special audit considerations of Circular A-133, including establishing an understanding with the auditee, initial-year audit considerations, the additional requirements of *Government Auditing Standards*, and audit materiality considerations.
- Describes the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements under generally accepted auditing standards (GAAS), *Government Auditing Standards*, and Circular A-133.
- Includes an entire chapter devoted to the determination of major programs and the risk-based approach.

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<sup>6</sup> To order a copy of the SOP, auditors should contact the AICPA Order Department at (888) 777-7077 (menu selection #1). See the section of this Audit Risk Alert titled "References for Additional Guidance" for additional ordering information.

- Describes the auditor's responsibility for reporting and provides illustrations of the reports required by *Government Auditing Standards* and Circular A-133.
- Describes the auditor's responsibility for testing and reporting in a program-specific audit and provides illustrations of the related reports.
- Includes an illustrative schedule of findings and questioned costs and illustrative schedules of expenditures of federal awards.

Further, the SOP incorporates guidance from the following documents:

- The Single Audit Act Amendments of 1996 and Circular A-133 (both of these documents are included in the appendix section of the SOP)
- Various AICPA Statements on Auditing Standards (SASs), including SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AU section 801)
- *Government Auditing Standards* (1994 revision)
- The OMB Circular A-133 Compliance Supplement

Auditors can obtain certain of the illustrative guidance included in the SOP (for example, the illustrative audit reports and schedules) in an electronic format from the AICPA's Web Site at [www.aicpa.org/belt/a133main.htm](http://www.aicpa.org/belt/a133main.htm).

.51 The AICPA is also working on a nonauthoritative implementation guide on Circular A-133. Auditors should watch future issues of the *CPA Letter* or the *Journal of Accountancy* for further information on this guide.

## Recent Auditing Pronouncements Issued

.52 SAS No. 83. In October 1997, the AICPA Auditing Standards Board (ASB) issued SAS No. 83, *Establishing an Understanding With the Client* (AU section 310), and Statement on Standards for Attestation Engagements (SSAE) No. 7, *Establishing an Understanding With the Client* (AT section 100). The SAS and the SSAE—

- Require the auditor to establish an understanding with the client that includes the objectives of the engagement, the responsibilities of management and the auditor, and any limitations of the engagement.
- Require the auditor to document the understanding with the client in the working papers, preferably through a written communication with the client.
- Provide guidance for situations in which the auditor believes that an understanding with the client has not been established.

The SAS also includes a listing of the matters that ordinarily would be addressed in the understanding with the client, and other contractual matters an auditor might wish to include in the understanding. SAS No. 83 and SSAE No. 7 are effective for engagements for periods ending on or after June 15, 1998, with early application permitted. Auditors should be aware that chapter 3 of SOP 98-3 also includes additional matters for auditors to consider including in the understanding with the client in an audit in accordance with *Government Auditing Standards* and Circular A-133.

.53 SAS No. 84. In October 1997, the ASB issued SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AU section 315). This Statement provides guidance on communications between predecessor and successor auditors when a change in auditors is in process or has taken place. It also provides



communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor. The SAS applies whenever an independent auditor is considering accepting an engagement to audit or reaudit financial statements in accordance with GAAS, and after such auditor has been appointed to perform such an engagement. SAS No. 84 is effective for engagements accepted after March 31, 1998, with early application permitted.

.54 **SAS No. 85.** In November 1997, the ASB issued SAS No. 85, *Management Representations* (AU section 333). The SAS establishes a requirement that an independent auditor, performing an audit in accordance with GAAS, obtain written representations from management for all financial statements and periods covered by the auditor's report. If current management was not present during all periods covered by the audit (which occurs frequently in government) the SAS requires the auditor to obtain written representations from current management on all such periods. Additionally, the SAS provides guidance concerning the representations to be obtained. An illustrative management letter is included in the Statement. SAS No. 85 is effective for audits of financial statements for periods ending on or after June 30, 1998, with early application permitted. Auditors should be aware that chapters 4 and 6 of SOP 98-3 also include additional representations for auditors to consider obtaining from management in an audit performed in accordance with *Government Auditing Standards* and Circular A-133.

.55 **SAS No. 86.** In March 1998, the ASB issued SAS No. 86, *Amendment to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AU section 634), to reflect the March issuance of SSAE No. 8, *Management's Discussion and Analysis* (AT section 700). SSAE No. 8 provides guidance on the performance of examinations and reviews of Management Discussion and Analysis (MD&A) prepared pursuant to the rules and regulations of the SEC. SAS No. 86 allows practitioners that have examined or reviewed MD&A in accordance with SSAE No. 8 to state that fact in the introductory section of the comfort letter and attach a copy of the SSAE No. 8 report to the comfort letter.

#### **Executive Summary—Recent Auditing Pronouncements**

New Auditing Standards include—

- SAS No. 83, *Establishing an Understanding With the Client* (AU section 310)
- SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AU section 315)
- SAS No. 85, *Management Representations* (AU section 333)
- SAS No. 86, *Amendment to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AU section 634)

### **Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting**

.56 Auditors with governmental clients that prepare their financial statements on the cash or modified cash basis of accounting should be aware that the AICPA Audit Issues Task Force (AITF) of the ASB has issued an auditing Interpretation of SAS No. 62, *Special Reports*, entitled "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting" (AU section 9623.88–.93). The Interpretation applies to cash, modified cash, and income tax basis presentations. It addresses the summary of significant accounting policies; disclosures for financial statement items that are the same as or similar to those prepared in conformity with generally accepted accounting principles (GAAP); issues relating to financial statement presentation; and disclosure of matters not specifically identified on the face of the statements. The Interpretation contains examples of how other comprehensive basis of accounting (OCBOA) disclosures, including presentation, may differ from those in GAAP financial statements.

.57 The Interpretation states that the discussion of the basis of accounting needs to include only the significant differences from GAAP and that quantifying differences is not required. If cash, modified cash, or income tax basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements either should provide the relevant GAAP disclosure or provide information that communicates the substance of that disclosure. Qualitative information may be substituted for some of the quantitative information required in a GAAP presentation. GAAP disclosure requirements that are not relevant to the measurement of the element, account, or item need not be considered.

.58 Cash, modified cash, and income tax statements should comply with GAAP requirements that apply to the presentation of financial statements or provide information that communicates the substance of those requirements. The substance of GAAP presentation requirements may be communicated using qualitative information and without modifying the financial statement format.

.59 Finally, if GAAP would require disclosure of other matters such as contingent liabilities, going concern, and significant risks and uncertainties, the auditor should consider the need for that same disclosure or disclosure that communicates the substance of those requirements. Such disclosures need not include information that is not relevant to the basis of accounting.

**Executive Summary—Disclosure in Financial Statements Prepared  
on the Cash, Modified Cash, or Income Tax Basis of Accounting**

- For cash, modified cash, or income tax basis financial statements, the discussion of the basis of accounting needs to include only the significant differences from GAAP. Quantifying differences is not required.
- If cash, modified cash, or income tax basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements either should provide the relevant GAAP disclosure or provide information that communicates the substance of that disclosure.
- Cash, modified cash, and income tax statements should comply with GAAP requirements that apply to the presentation of financial statements or provide information that communicates the substance of those requirements.

## Restricting the Use of an Auditor's Report

.60 Both the report on compliance and internal control over financial reporting issued by the auditor in an audit of financial statements performed in accordance with *Government Auditing Standards* and the report issued on compliance and internal control over compliance in a Circular A-133 audit are considered restricted use reports. For this reason, auditors of governmental entities should be aware that in January 1998, the ASB issued an exposure draft of a proposed SAS entitled, *Restricting the Use of an Auditor's Report*, which would be effective for reports issued after November 30, 1998. The proposed SAS provides guidance to auditors that will help them determine whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The proposed SAS states that an auditor should restrict the use of a report in the following circumstances:

- The subject matter of the auditor's report, or the presentation being reported on, is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in accordance with GAAP or OCBOA.
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

In addition to describing the circumstances in which the use of an auditor's report should be restricted, the proposed Statement, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used in restricted-use reports, and requires an auditor to restrict a "combined" report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report. Auditors should be alert for the issuance of a final SAS.

## The Year 2000 Issue

*How will the arrival of the year 2000 affect a government's accounting and financial information systems? What issues need to be addressed this year?*

.61 *The Year 2000 Issue.* The year 2000 (Y2K) issue consists of two shortcomings of many electronic data processing systems that make them unable to process year-date data accurately beyond the year 1999. It is a broad operational problem, as well as an accounting systems problem.

.62 The first shortcoming is that, in the past, computer programmers have consistently abbreviated dates by eliminating the first two digits of the year under the assumption that these two digits would always be 19. Thus, January 1, 1965, became 01/01/65. Unless corrected, this shortcut is expected to create widespread problems when the clock strikes 12:00:01 A.M. on January 1, 2000. On that date, some computer programs may recognize the date as January 1, 1900, and consequently will process data inaccurately or stop processing altogether.

.63 The second shortcoming is that the algorithm used in some computers for calculating leap years is unable to detect that the year 2000 is a leap year. Therefore, systems that are not year 2000 compliant may not register the additional day, and date calculations may be incorrect.

.64 The year 2000 issue also may affect computer applications before January 1, 2000. Failures are expected to occur when systems attempt to perform calculations into the year 2000 (for example, some entities may not be able to process a credit card that expires in the year 2000 or beyond).

.65 In addition, some software programs use several dates in the year 1999 to mean something other than the date. Examples of such dates are 01/01/99, 09/09/99, and 12/31/99. As systems process information using these dates, they may produce erratic results or stop functioning.

.66 Entities may experience other problems relating to the year 2000 issue. For example, inventory-control systems may treat new items as obsolete, receivables may be erroneously identified as past due, interest calculations may be incorrect, paid-up insurance policies may be considered expired, and computerized equipment-maintenance schedules may be adversely affected, along with the expiration dates for periodical subscriptions.

.67 To further complicate matters, even if a governmental entity's systems are year 2000 compliant, the entity may be affected by noncompliant systems of grantors, customers, vendors, or third-party data-processing services with which the entity interacts electronically.

.68 The costs to make systems year 2000 compliant may be substantial. The Gartner Group, an international information technology advisory and market research firm, has estimated the global costs to make software year 2000 compliant to be between \$300 billion and \$600 billion through 1999.

.69 In addition to the costs of making software year 2000 compliant, entities should understand that the risk of litigation relating to the year 2000 issue is substantial.

.70 *Auditors and the Year 2000 Issue.* The AITF has issued two Interpretations of auditing standards addressing the year 2000 issue and expects to issue a third Interpretation by June 1998. The Interpretations provide guidance to the auditor regarding his or her responsibilities in an audit conducted in accordance with GAAS. The following is a summary of what the Interpretations cover:

- Interpretation No. 3 of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, entitled "Responsibilities of Service Organizations and Service Auditors With Respect to Information about the Year 2000 Issue in a Service Organization's Description of Controls" (AU section 9324.19-.31). This Interpretation clarifies the responsibilities of service organizations and service auditors with respect to information about the year 2000 issue in a service organization's description of controls.
- Interpretation No. 4 of SAS No. 22, *Planning and Supervision*, entitled "Audit Considerations for the Year 2000 Issue" (AU section 9311.38-.47). This Interpretation discusses the auditor's responsibility with regard to the year 2000 issue, how the issue affects planning for an audit of financial statements conducted in accordance with GAAS, and under what circumstances the issue may result in a reportable condition.
- The third Interpretation is expected to be available on the AICPA's Web Site on or before June 30, 1998. It will provide guidance on the application of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341), to the year 2000 issue.

.71 Because of the publicity that the year 2000 issue has received, some entities might decide to make disclosures regarding their system's year 2000 readiness. Auditors should be extremely cautious about being associated with assertions that clients' systems are year 2000 compliant or guarantees that systems will become compliant by a specified date.

.72 If voluntary disclosures about the year 2000 issue are included in the notes to the audited financial statements of a governmental entity, the auditor should determine whether he or she has obtained sufficient competent evidential matter regarding the information disclosed. The auditor may conclude that voluntary disclosures regarding the year 2000 issue should be made outside of the financial statements or labeled as unaudited, especially if such disclosures contain subjective or forward-looking information. The auditor's responsibility with respect to these disclosures depends on whether the disclosures appear in an auditor-submitted document or a client-submitted document. The auditor's responsibilities in each of these situations are as follows:

- *Unaudited disclosures in a client-submitted document.* If disclosures about the year 2000 issue are presented outside the financial statements of a governmental entity or other documents to which the auditor, at the client's request, devotes attention, the auditor is responsible for reading and considering the information pursuant to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AU section 550).
- *Unaudited disclosures in an auditor-submitted document.* The auditor should refer to SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AU section 551). If the auditor concludes, on the basis of facts known to him or her, that any accompanying information is materially misstated in relation to the basic financial statements taken as a whole, SAS No. 29, paragraph 9, states that the auditor should discuss the matter with the client and propose appropriate revision of the accompanying information. If the client will not revise the accompanying information, the auditor should either modify his or her report on the accompanying information and describe the misstatement or refuse to include the information in the document.

.73 An important part of any firm's risk management program related to the year 2000 issue is its timely and ongoing communication with the client's management. To avoid misunderstandings about the auditor's responsibilities with respect to the year 2000 issue, an auditor may find it necessary to specifically set forth his or her responsibilities under current auditing standards in communications with the client during audits leading up to the year 2000. Communications with the client may be in the form considered most appropriate

by the auditor. Some forms of communication that auditors may wish to consider are discussed in the following paragraphs.

.74 SAS No. 83 requires auditors to obtain an understanding with the client regarding the service to be performed, including the objectives and limitations of an audit of financial statements (see the section in this Audit Risk Alert titled “Recent Auditing Pronouncements”). Auditors may wish to specifically address the year 2000 issue in connection with obtaining that understanding. The AICPA’s publication, *The Year 2000 Issue: Current Accounting and Auditing Guidance*, contains sample engagement letter language relating to the year 2000 issue. The publication is available free of charge from the AICPA’s Web Site ([www.aicpa.org](http://www.aicpa.org)) or for a small charge from the AICPA’s order department at (888) 777-7077.

.75 Auditors may wish to discuss the year 2000 issue with a client’s audit committee (or individual or group with similar responsibilities) to make sure they understand the year 2000 issue and its magnitude. Paragraph 6 of SAS No. 61, *Communications With Audit Committees*, (AU section 380) provides as follows:

An audit performed in accordance with [GAAS] may address many matters of interest to an audit committee. For example, an audit committee is usually interested in internal control and in whether the financial statements are free of material misstatements. In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed for these matters under [GAAS]. It is also important for the audit committee to understand that an audit conducted in accordance with [GAAS] is designed to obtain reasonable, rather than absolute, assurance about the financial statements.

Because the year 2000 issue may affect an entity’s internal control an auditor may wish to advise an entity’s audit committee that because an audit is not intended to provide assurance on the effectiveness of internal control, an audit of financial statements in accordance with GAAS does not provide any assurance with respect to the year 2000 issue.

.76 Through inquiries of client personnel, the auditor may obtain information regarding the client’s understanding of the year 2000 issue and, if applicable, the progress of its year 2000 compliance efforts. The auditor may wish to communicate to senior management and the audit committee the results of such inquiries and any observations regarding the year 2000. However, auditors should be cautious in these communications not to imply that they are providing assurance on year 2000 compliance.

.77 Depending on the entity’s reliance on date-dependent processing and the state of preparedness for the year 2000, the auditor also may want to address certain other situations relating to the year 2000 issue in his or her management letter. Some of these situations may be as follows:

- The client has not begun to address the year 2000 issue.
- The client recognizes the issue but needs to develop a year 2000 compliance program.
- The client recognizes the issue but needs to assess the effect of the year 2000 issue on its systems.
- The client needs to consider the budget and resource implications of the plan.
- The client currently is not meeting its year 2000 compliance project’s timetables.

The matters discussed herein are more fully described in the AICPA’s publication, *The Year 2000 Issue: Current Accounting and Auditing Guidance*.

.78 Auditors should also consider whether costs associated with their clients’ modifications of computer systems pursuant to the year 2000 issue have been properly accounted for. Costs specifically associated with modifying software for the year 2000 should generally be charged to expenditures 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.

#### **Executive Summary—The Year 2000 Issue**

- The year 2000 issue has the potential to affect, among other things, an entity's accounting and information systems.
- The AITF has issued guidance on the auditor's responsibility to detect year 2000 issues; audit planning considerations; and the circumstances under which year 2000 issues may constitute reportable conditions. It also issued an Interpretation to SAS No. 70, clarifying the responsibilities of service organizations and service auditors with respect to information about the year 2000 issue in a service organization's description of controls. Another Interpretation on the application of SAS No. 59 to the year 2000 issue is expected in June.
- Auditors should be familiar with their responsibility regarding the different disclosures that many organizations may make relating to the year 2000 issue. They should be extremely cautious about being associated with assertions that clients' systems are year 2000 compliant or guarantees that systems will become compliant.
- To avoid misunderstandings about the auditors' responsibilities with respect to the year 2000 issue, an auditor may wish to specifically set forth his or her responsibilities under current auditing standards in communications with the client during audits leading up to the year 2000. Those communications may be in the form of engagement letters or management letters.
- Auditors should consider client accounting for the year 2000 issue.

### **Using the Work of an Actuary**

#### *What are the auditor's responsibilities when using the work of an actuary?*

.79 The Governmental Accounting Standards Board's (GASB) new pension rules (see the discussion in the section of this Audit Risk Alert titled "Accounting Issues and Developments") generally require actuarial involvement of some sort. Because the auditor's qualifications do not typically encompass actuarial science or the complexities of probability and longevity associated with life contingencies, the auditor should consider using the work of the actuary. In that connection, the auditor should follow the guidance in SAS No. 73, *Using the Work of a Specialist* (AU section 336), to obtain assurance regarding the work of the actuary. Chapter 14 of the Audit and Accounting Guide *Audits of State and Local Governmental Units* provides useful guidance on accounting and auditing considerations of government pension-related matters. Also, because audit procedures used in auditing governmental pension plans differ little in most areas from those used in auditing private sector pension plans, auditors should consider referring to the Audit and Accounting Guide *Audits of Employee Benefit Plans* for additional audit guidance.

.80 As part of an audit of pension trust funds, pension plans, or the financial statements of a governmental employer that provides or participates in a pension plan, the auditor should consider sending a request to the actuary to confirm certain information taken from the actuary's report. Appendix C to this Audit Risk Alert includes an illustration of a confirmation that could be used by the auditor in such a situation.

.81 Whenever using the work of an actuary (for pension-related matters or for other matters), auditors should note that SAS No. 73, among other things, requires auditors to obtain an understanding of the nature of the work performed by the specialist. The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (1) obtain an understanding of the methods and assumptions used by the specialist, (2) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (3) evaluate whether the specialist's findings support the related assertions in the financial statements. See SAS No. 73 for further details.

## Indemnification Clauses

*What is the significance of an indemnification clause in an engagement letter? Should an auditor indemnify a client?*

.82 Although no authoritative pronouncements currently require that a written engagement letter be used in an audit, its use is generally considered to be sound business practice. Engagement letters can help prevent misunderstandings between the client and the auditor regarding the services to be performed and the responsibilities of both parties. In addition, states generally recognize the engagement letter as a legally binding document, and its use may therefore help reduce the risk of litigation.

.83 In efforts to further reduce those risks, practitioners have increasingly begun to incorporate so-called indemnification clauses into their engagement letters. Typically, indemnification clauses provide recourse to the auditor if he or she is sued for alleged audit failures, given that the auditor has relied on representations by management that were later discovered to be false.

.84 In a recently reported lawsuit, a CPA firm won a six-figure settlement from a former financial institution client that blamed its bankruptcy on alleged audit failures even though the client had lied to the firm's auditors about issues that had been raised by federal regulators. In its engagement letter, the firm had included an indemnification clause providing that the client would be responsible for paying any legal fees incurred by the firm due to its reliance on any false representations made by the client. On the basis of that clause, the firm was able to negotiate a favorable settlement from a position of relative strength. Successful resolutions to litigation against auditors, such as this one, have spurred many in the profession to adopt, or at the very least consider, the possibility of the inclusion of indemnification clauses in their engagement letters. Although some question whether such clauses add anything legally to common law, others believe that including the clause in the engagement letter, at the very least, puts the client on notice about precisely what their responsibilities are for the financial statements and their representations.

.85 From the standpoint of auditor independence, this issue is addressed in AICPA Ethics Ruling No. 94, *Indemnification Clause in Engagement Letters* (AICPA, *Professional Standards*, vol. 2, ET sec. 191). The ruling provides that an auditor's independence is not impaired solely on the basis of an agreement whereby the client would hold the member harmless from any liability and costs resulting from knowing misrepresentations by management.

.86 Regulators, including the SEC, may restrict or prohibit liability limitations such as indemnification clauses. Auditors who wish to use indemnification clauses in an engagement letter should consider consulting with legal counsel before using this clause.

.87 Auditors are also reminded of Ethics Ruling No. 102, *Member's Indemnification of a Client* (AICPA, *Professional Standards*, vol. 2, ET sec. 191), that was issued in January 1996. 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. The use of such clauses by state and local governments in requests for proposals (RFP) and audit contracts have been on the increase. Therefore, auditors should carefully review RFPs and audit proposals for such clauses before entering into them.

### Executive Summary—Indemnification Clauses

- Though a written engagement letter is not required, it is a good idea to have one.
- Indemnification clauses in engagement letters may help reduce the auditor's exposure to litigation stemming from representations made to the auditor.
- Indemnification clauses in engagement letters do not impair independence.
- 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.

## Accounting Issues and Developments

.88 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 1998. Other standards will not be effective until after 1998; 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 1998

#### *What GASB Statements become effective during the next year?*

.89 *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*
- 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 healthcare plans. GASB Statement Nos. 25 and 26 were 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.

.90 Also, the GASB issued Technical Bulletin (TB) 96-1, *Application of Certain Pension Disclosure Requirements for Employers Pending Implementation of GASB Statement No. 27*, in August 1996. GASB TBs are recognized in category (b) of the hierarchy of GAAP 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). TB 96-1 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.

.91 Since the release of GASB Statement Nos. 25, 26, and 27, many questions have been posed to GASB staff regarding the implementation of these Statements and their application in various plan and employer reporting situations. To assist in applying the provisions of the pension-related Statements, the GASB issued an Implementation Guide titled, *Guide to Implementation of GASB Statements 25, 26, and 27 on Pension Reporting and Disclosure by State and Local Government Plans and Employers*, in June 1997. GASB Implementation Guides are recognized in category (d) of the hierarchy of GAAP in SAS No. 69. The guide includes questions and answers that were for the most part derived from technical inquiries received by GASB staff. The questions and answers are intended to serve two purposes: (1) they can be used as ready references by users with similar questions, and (2) they illustrate a basis for resolving issues that users can apply to questions or situations not specifically addressed in the guide.

.92 Last, auditors should be aware that in implementing GASB Statement No. 25 some governments have been incorrectly leaving the pension activity in the Statement of Revenues, Expenses, and Changes in



Retained Earnings/Fund Balances instead of reporting a separate Statement of Changes in Net Assets. For each defined benefit pension plan, GASB Statement No. 25 requires two financial statements—a Statement of Plan Net Assets and a Statement of Changes in Plan Net Assets—and two schedules presented as required supplementary information—the Schedule of Funding Progress and the Schedule of Employer Contributions. For governments that include pension trust funds as part of their general purpose financial statements (GPFS) or comprehensive annual financial report (CAFR), the GASB permits the information that would be included in the Statement of Net Assets to be included in the Combined Balance Sheet and (when more than one plan is included or a single plan is combined with another trust or agency fund) the Combining Balance Sheet for Fiduciary Funds. However, auditors should be aware that a separate Statement of Changes in Net Assets is still required as an addition to the GPFS and (when more than one plan is included or a single plan is combined with another trust or agency fund) the Combining Statement of Changes in Net Assets in the CAFR. This is a change from past practice where pension trust funds were included in the Combined (and possibly Combining) Statement of Revenues, Expenses, and Changes in Retained Earnings/Fund Balances. As a result, applicable governments will have six statements in the GPFS, rather than the previous five. Moreover, when the GPFS is issued separately, combining statements for defined benefit pension plans should be presented in the GPFS to satisfy the requirement in GASB Statement No. 25 for separate reporting on each plan.

**.93 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, 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 include most certificates of deposit) should be reported using a cost-based measure.

**.94** 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 at the balance sheet date.

**.95** For defined benefit pension plans and IRC Section 457 deferred compensation plans, Statement No. 31 provides guidance for applying fair value to certain investment transactions.

**.96** To assist in implementing GASB Statement No. 31, the GASB issued an Implementation Guide in April 1998. The objective of this guide is to answer commonly asked questions about the implementation of GASB Statement No. 31. The key issue is the application of fair value accounting to governmental statements and, in particular, in the context of external investment pools.

**Executive Summary—GASB Statements Effective During 1998**

- GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, is effective for periods beginning after June 15, 1997, with early implementation encouraged.
- GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, is effective for financial statements for periods beginning after June 15, 1997.
- The GASB has published implementation Guides on the GASB pension-related Statements and GASB Statement No. 31 have been issued.

**GASB Statements Effective After 1998, With Early Application Encouraged***What other GASB Statements have been issued recently?*

.97 *Internal Revenue Code Section 457 Deferred Compensation Plans.* In October 1997, the GASB issued GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*, which is effective for financial statements for periods beginning after December 31, 1998, or when plan assets are held in trust under the requirements of IRC Section 457, subsection (g), if sooner. This Statement was issued as a result of amendments that were made in August 1996, to the provisions of IRC Section 457, which require these plans to hold all assets in trust for the exclusive benefit of participants and their beneficiaries. Before this change, 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. GASB Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted Under Provisions of Internal Revenue Code Section 457*, was based on that premise and, therefore, it generally required that IRC Section 457 plans be displayed in an agency fund.

.98 GASB Statement No. 32 rescinds GASB Statement No. 2 and establishes accounting and financial reporting standards for IRC Section 457 deferred compensation plans of state and local governmental employers. In addition, this Statement amends the investment guidance for IRC Section 457 plans in GASB Statement No. 31.

.99 Under GASB Statement No. 32, an IRC Section 457 deferred compensation plan that meets the criteria in National Council on Governmental Accounting (NCGA) Statement 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 26(3)(8), for inclusion in the fiduciary funds of a government should be reported as an expendable trust fund in the financial statements of that government. Paragraph 26(3)(8) of NCGA Statement 1 states that trust and agency funds are used to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. Therefore, the government will need to exercise judgment in determining whether they have fiduciary accountability for IRC Section 457 plans and whether they hold the assets in a trustee capacity. Research conducted by the GASB indicates that most sponsors of IRC Section 457 plans have little administrative involvement and do not perform the investing functions for these plans. This is consistent with practice for other types of plans (for example, governments that have 401(k) or 403(b) plans or other deferred compensation plans currently determine if the NCGA criteria apply to those plans). Governments generally have interpreted the NCGA guidance as not requiring the use of fiduciary funds in situations where assets are administered by a third party. As a result, since many governments rely on third parties to manage IRC Section 457 plan assets, the likely result of GASB Statement No. 32 is that many government employers that currently report IRC Section 457 plan assets on their balance sheet will no longer do so.

**GASB Interpretations Effective After 1998, With Early Application Encouraged**

.100 *Property Tax Revenue Recognition.* In November 1997, the GASB issued GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds, an Interpretation of NCGA Statement 1 and an Amend-*

ment of NCGA Interpretation 3, which is effective for financial statements for periods beginning after June 15, 2000, with early application encouraged. This Interpretation amends NCGA Interpretation 3, *Revenue Recognition—Property Taxes*, by modifying the definition of *available* as the term relates to property tax revenue recognition using the modified accrual basis of accounting. The effect of this amendment is to remove the “due ” consideration from the definition of *available* established in NCGA Interpretation 3. The revised definition of *available* is as follows: “*Available* means collected within the current period or expected to be collected soon enough thereafter to be used to pay liabilities of the current period.” Auditors should note, however, that this Interpretation does not change the stipulation that the collection period after year end shall not exceed sixty days.

## **GASB Technical Bulletins Effective During 1998**

**.101** *Classification of Deposits and Investments.* In November 1997, the GASB issued TB 97-1, *Classification of Deposits and Investments into Custodial Credit Risk Categories for Certain Bank Holding Company Transactions*, which clarifies the reporting of deposits and investments for certain bank holding company transactions. It is effective for financial statements for periods beginning after December 15, 1997, with early application encouraged.

**.102** The TB provides the Board’s answers to two questions on applying GASB Statement No. 3, *Deposits With Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*, that have arisen due to the growth in bank mergers and holding companies. GASB Statement No. 3 established three categories for classifying the custodial credit risk inherent in deposits and investment transactions. Question No. 1 in the TB addresses the issue of classifying deposits and investments when the counterparty and the custodial agent are subsidiary banks of the same bank holding company. In this situation the TB states that the deposits and investments should be classified in category 3. If, however, the deposits are insured, the deposits should be classified in category 1. If the investments are insured or registered, the investments should be classified in category 1. Question No. 2 focuses on the classification of deposits and investments when the counterparty is a “section 20” subsidiary and the bank-custodial agent is controlled by the same bank holding company. In this situation, the deposits and investments should be classified in category 2, provided that the securities are held in the name of the entity by the bank-custodial agent. If, however, the deposits are insured, the deposits should be classified in category 1. If the investments are insured or registered, the investments should be classified in category 1.

## **GASB Exposure Drafts Outstanding**

**.103** *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. Due to the large number of public comments received and the numerous issues raised, the GASB continues its deliberations on this project. At the time of the issuance of this Audit Risk Alert, it is not known whether the GASB will issue a final Statement during the next year or whether a revised exposure draft will be issued for additional public comment. Auditors should closely follow the developments related to this project.

**.104** *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. At the time of the issuance of this Audit Risk Alert, it is not known whether the GASB will issue a final Statement during the next year or whether a revised exposure draft will be issued for additional public comment. Auditors should closely follow the developments related to this project.

**.105** *Accounting and Financial Reporting for Nonexchange Transactions.* Issued in March 1997, this exposure draft would establish accounting and financial reporting standards for nonexchange transactions. Nonexchange transactions are those in which a government gives (or receives) value without directly receiving (or

giving) equal value in exchange. At the time of the issuance of this Audit Risk Alert, it is not known whether the GASB will issue a final Statement during the next year or whether the Board will delay the issuance of a final Statement until the deliberations on the financial reporting model projects are completed. Auditors should closely follow the developments related to this project.

**.106** *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 the end of 1998.

## Other Accounting Matters

**.107** *Accounting for the Costs of Joint Activities.* In March 1998, the AICPA issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*. The SOP applies to not-for-profit organizations and state and local governmental entities in determining fund-raising costs. It supersedes SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*. SOP 98-2 requires state and local governmental 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 each met, subject to the exception in the following sentence. Costs of goods or services provided in exchange transactions, such as costs of direct donor benefits of a special event (for example, a meal), should not be reported as fundraising. If the criteria of purpose, audience, and content are met, the joint costs of those activities should be allocated, and costs that are clearly identifiable with fund-raising, program, or management and general functions should be charged to those cost objectives.

**.108** SOP 98-2 is effective for years beginning on or after December 15, 1998. Some entities will undoubtedly change the way they conduct their activities in order to meet the allocation criteria. The lead time on conducting such activities can be as long as six months. Auditors should discuss the SOP with their clients and start reviewing their activities now to plan for implementation of the SOP.

## References for Governmental Accounting and Auditing Guidance

### AICPA

**.109** *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. 012057).
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (No. 014887).
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (No. 014904).
- *Checklists and Illustrative Financial Statements for State and Local Governmental Units* (No. 008697).
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*—This practice aid walks auditors through issues likely to be encountered in applying SAS No. 82 to audits, including valuable tools such as sample documentation. It also provides specific guidance on applying the concepts of the SAS to various industries, including government (No. 008883).

- *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 (No. 990004) to help users identify and report on potential control deficiencies.

.110 *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-Assisted Projects
- Advanced Auditing of HUD-Assisted Projects
- Compliance Auditing
- Cost Principles for Nonprofit Organizations under OMB Circular A-133
- Governmental Auditing and Accounting Update
- Solving Complex Single Audit Issues for Governmental and Nonprofit Organizations
- Single Audit Requirements for Nonprofit and Government Organizations
- Workpaper Preparation Techniques for Government and Nonprofit Organizations
- Yellow Book: *Government Auditing Standards*
- Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits

.111 Self-study courses include the following:

- Audits of Public and Indian Housing Authorities
- Performance Auditing
- 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 or Local Government
- Yellow Book: *Government Auditing Standards*
- Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits
- HUD Audits: A Comprehensive Guide
- Governmental Auditing and Accounting Update
- Compliance Auditing
- Audits of Rural Development and Housing Programs
- Communicating Material Noncompliance and Internal Control Weaknesses

.112 The following video courses are also available:

- Effective Yellow Book Auditing
- 1997 Government Auditing and Accounting

.113 To order AICPA products, call (888) 777-7077 (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. The best times to call are 8:30 A.M. to 11:30 A.M. and 2:00 P.M. to 7:30 P.M., EST. Obtaining product information and placing online orders can be done at the AICPA's Web Site (<http://www.aicpa.org>).

.114 *Industry Conferences.* The AICPA will hold its fifteenth annual National Governmental Accounting and Auditing Update Conference on August 17–19, 1998, in Washington, D.C., and again on September 14–15, 1998, in Denver, Colorado. 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 and Not-for-Profit Training Program. This year's program will be held on October 26–28, 1998, in New Orleans, Louisiana. 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 (888) 777-7077.

.115 *Accounting and Auditing Technical Hotline.* The Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

.116 *Ethics Hotline.* Members of the AICPA's Professional Ethics Team answers inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

.117 *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 stay abreast of developments in accounting and auditing. 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 email 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.

.118 *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

.119 The GASB offers the following publications and services:

- *Codification of Governmental Accounting and Financial Reporting Standards*, as of June 30, 1997 (GCD97)—An edition as of June 30, 1998, is expected to be issued in late summer 1998.
- *GASB Original Pronouncements*, as of June 30, 1997 (GOP97)—An edition as of June 30, 1998, is expected to be issued in late summer 1998.
- *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, 14, 25, 26, 27, and 31.

- *GASB Home Page*—Information about the GASB can be found on a World Wide Web home page site. The GASB address is <http://www.gasb.org>. 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 email 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

.120 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*.

.121 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*.

## General Accounting Office

.122 General Accounting Office (GAO) publications and services 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 on the GAO home page and are also for sale 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. An interactive version of *Government Auditing Standards* is available on the IGnet home page (<http://www.ignet.gov>). Auditors should note that the GAO is currently working on revisions to Government Auditing Standards (see the related discussion in the section of this Audit Risk Alert titled “Regulatory, Legislative, and Other Developments”).
- *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 on the GAO home page and is also for sale from the GPO, Superintendent of Documents, Washington, DC 20401.

.123 *How to Get Action on Audit Recommendations*—This guide is designed 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).

**.124 GAO on the World Wide Web.** GAO issues hundreds of reports and testimony to the Congress each year on a wide variety of subjects, including accounting and budgeting and financial management. Now the full text of GAO products can be retrieved via the Internet. GAO's home page is at <http://www.gao.gov>. Service is available twenty-four hours a day. For information on how to access GAO reports or other documents on the Internet, send an email message to [info@www.gao.gov](mailto:info@www.gao.gov). GAO's home page is updated daily and includes—

- The GAO Daybook, a daily listing of released reports and testimony.
- An electronic version of *Government Auditing Standards*.
- An electronic version of *Interpretation of Continuing Education and Training Requirements*.
- The monthly catalog of Reports and Testimony (with links to most documents listed).
- Reports and testimony released since the last monthly catalog.
- Comptroller General Decisions and legal opinions.
- GAO Policy Documents.
- Special Publications, including GAO Annual Index and GAO Annual Report.

Unless otherwise noted above, requests for copies of the publications described above should be sent to the GAO, P.O. Box 37050, Washington, DC 20013. The telephone number is (202) 512-6000. Orders may also be placed by using the fax number (202) 512-6061.

## Office of Management and Budget

**.125 Circulars.** The 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 in the following table. 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/Grants>. An alternate address is the IGnet home page at <http://www.ignet.gov>.

**OMB Circulars Relevant to Audits of State and Local Governments and Not-for-Profit Organizations**

<u>Circular Number</u>	<u>Applicability</u>	<u>Issue Date</u>
A-21 (Revised)	Cost principles for educational institutions	May 1998
A-87 (Revised)	Cost principles for state, local, and Indian tribal governments	August 1997
A-102 (Revised)	Grants and cooperative agreements with state and local governments	August 1997
A-122 (Revised)	Cost principles for nonprofit organizations	May 1998
A-133 (Revised)	Audits of states, local governments, and nonprofit organizations	June 1997



**.126 OMB Circular A-133 Compliance Supplement.** The OMB Compliance Supplement, issued as a provisional document on June 30, 1997, sets forth the major federal compliance requirements that should be considered in a single audit of states, local governments, and not-for-profit organizations that receive federal awards. Another revision to the Supplement is expected to be issued by mid 1998. A separate discussion of the *Compliance Supplement* appears in the section of this Audit Risk Alert entitled "Regulatory, Legislative, and Other Developments."

**.127 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>.

**.128** 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.

**.129** 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

**.130** The President's Council on Integrity and Efficiency (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.

**.131** Over the years, the PCIE Audit Committee (or its predecessors) has issued a total of six position statements. Most of these position statements were developed to address issues related to audits conducted under the Single Audit Act of 1984, Circular A-128, and the March 1990 version of Circular A-133. Only PCIE Statement No. 4, which establishes uniform procedures for referrals of substandard audits to state boards of accountancy and the AICPA, continues to be applicable to audits conducted under the Single Audit Act Amendments of 1996 or the June 1997 Circular A-133.

**.132** PCIE Statement No. 4 is 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. It is also available on IGnet, the Inspectors General Internet site, in the Single Audit Library. The Internet address is <http://www.ignet.gov/ignet/single/pcie.html>.

## Government Finance Officers Association

**.133** 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.gfoa.org>. GFOA publications include the following:

- *Governmental Accounting, Auditing, and Financial Reporting (GAAFR)*—The 1994 GAAFR, which only includes accounting standards issued through 1994, 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 through February 1996. It also includes relevant articles from the newsletter on the proper application of the provisions of GASB pronouncements.
- *Recommended Practices for State and Local Governments*—The 1997 update is a compilation of recommended practices in public financial management. They are intended to identify enhanced techniques and provide effective strategies for state and local governments. The recommended practices are presented in the areas of accounting, auditing, and financial reporting; cash management; budgeting and financial management; debt management; and retirement and benefits administration.
- *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*

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.134 This Audit Risk Alert replaces *State and Local Governmental Developments—1997*.

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.135 Auditors should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1997/98* [AAM section 8010] and *Compilation and Review Alert—1997/98* [AAM section 8015], which may be obtained by calling the AICPA Order Department at the number below and requesting publication number 022202 (audit) or 060681 (compilation and review).

.136 Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (888) 777-7077. Copies of FASB and GASB publications referred to in this document can be obtained directly from the FASB or GASB by calling the FASB/GASB Order Department at (203) 847-0700, ext. 10.

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## Appendix A

### References to Useful Web Sites

The following listing summarizes the various Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of state and local governments may find useful:

<i>Organization</i>	<i>Web Site Address</i>
AICPA	<a href="http://www.aicpa.org">http://www.aicpa.org</a>
Federal Audit Clearinghouse	<a href="http://harvester.census.gov/sac">http://harvester.census.gov/sac</a>
FinanceNet	<a href="http://www.financenet.gov">http://www.financenet.gov</a>
Federal Tax Code Search	<a href="http://tns.lcs.mit.edu.80">http://tns.lcs.mit.edu.80</a>
Fedworld	<a href="http://fedworld.gov/uscode">http://fedworld.gov/uscode</a>
General Accounting Office	<a href="http://www.gao.gov">http://www.gao.gov</a>
General Services Administration	<a href="http://www.gsa.gov">http://www.gsa.gov</a>
Governmental Accounting Standards Board	<a href="http://www.gasb.org">http://www.gasb.org</a>
Government Finance Officers Association	<a href="http://www.gfoa.org">http://www.gfoa.org</a>
House of Representatives	<a href="http://www.house.gov">http://www.house.gov</a>
IGnet	<a href="http://www.ignet.gov">http://www.ignet.gov</a>
IRS Digital Daily	<a href="http://www.irs.ustreas.gov/prod">http://www.irs.ustreas.gov/prod</a>
Library of Congress	<a href="http://lcweb.loc.gov/homepage">http://lcweb.loc.gov/homepage</a>
U.S. Department of Education Office of Inspector General Non-Federal Audit Team	<a href="http://www.gvi.net/~edoig/">http://www.gvi.net/~edoig/</a>
U.S. Department of Housing and Urban Development Office of Inspector General	<a href="http://www.hud.gov/oig.html">http://www.hud.gov/oig.html</a>
U.S. Office of Management and Budget <ul style="list-style-type: none"> <li>• Main page</li> <li>• Grants Management Circulars</li> </ul>	<a href="http://www.whitehouse.gov/WH/EOP/omb">http://www.whitehouse.gov/WH/EOP/omb</a> <a href="http://www.whitehouse.gov/WH/EOP/OMB/Grants">http://www.whitehouse.gov/WH/EOP/OMB/Grants</a>
U.S. Securities and Exchange Commission	<a href="http://www.sec.gov">http://www.sec.gov</a>
Thomas Legislative Search	<a href="http://thomas.loc.gov">http://thomas.loc.gov</a>

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## Appendix B

### Federal Agency Listing for Assigning CFDA Numbers

<i>CFDA Agency Number</i>	<i>Federal Agency Name</i>
01	African Development Foundation
02	Agency for International Development
10	Agriculture
23	Appalachian Regional Commission
88	Architectural & TransBarriers Compliance
11	Commerce
29	Commission on Civil Rights
78	Commodity Futures Trading Commission
87	Consumer Product Safety Commission
94	Corporation for National & Community Service
12	Defense
84	Education
81	Energy
66	Environmental Protection Agency
30	Equal Employment Opportunity Commission
32	Federal Communications Commission
83	Federal Emergency Management Agency
33	Federal Maritime Commission
34	Federal Mediation and Conciliation Service
36	Federal Trade Commission (FTC)
39	General Services Administration
40	Government Printing Office
93	Health and Human Services
14	Housing and Urban Development
03	Institute for Museum Services
04	Inter-American Foundation
15	Interior
61	International Trade Commission
41	Interstate Commerce Commission
16	Justice
17	Labor
42	Library of Congress
91	Miscellaneous Foundations & Commissions

<i>CFDA Agency Number</i>	<i>Federal Agency Name</i>
43	National Aeronautics & Space Administration
89	National Archives & Records Administration
92	National Council on Disability
44	National Credit Union Administration
05	National Endowment for the Arts
06	National Endowment for the Humanities
68	National Gallery of Art
46	National Labor Relations Board
47	National Science Foundation
77	Nuclear Regulatory Commission
07	Office of National Drug Control Policy
27	Office of Personnel Management (OPM)
70	Overseas Private Investment Corporation
08	Peace Corps
86	Pension Benefit Guaranty Corporation (PBGC)
53	Presidential Commission on Employment of the Handicapped
57	Railroad Retirement Board
85	Scholarship Foundations
58	Securities and Exchange Commission (SEC)
59	Small Business Administration
60	Smithsonian Institution
96	Social Security Administration
19	State
62	Tennessee Valley Authority (TVA)
20	Transportation
21	Treasury
82	United States Information Agency
64	Veterans Affairs

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## Appendix C

### Illustrative Request to Actuary for Confirmation of GASB Pension Information

#### Instructions

This illustrative letter, which accompanies draft pension information for notes to the financial statements, required supplementary information, and any other appropriate GASB pension presentation, is prepared on the client's letterhead and mailed by the auditor in envelopes bearing the auditor's return address.

It is used when auditing the financial statements of all state and local governmental employers that provide or participate in pension plans, including general purpose governments, public benefit corporations and authorities, utilities, hospitals and other healthcare providers, colleges and universities, and public employee retirement systems that are employers. It also is used when auditing pension plans or retirement systems included as pension trust funds or component units in the financial reports of plan sponsors or employers. These pension plans and retirement systems provide retirement income and also may provide other types of postemployment benefits.

In determining which individuals to include in the Listing of Selected Pension Plan Participant Census Data (illustrated as an attachment to the actuary request letter), the auditor may consider the following suggestions:

- Include the lesser of 20 individuals or 10 percent of participants, but no more than 200 individuals.
- Include samples from actives, retirees, and terminated vested.
- If plan has multiple benefit provisions, include a sample of each group.

[Date]

[Name of Actuary]

Name of Actuarial Firm

Address of Actuarial Firm]

Dear [Name of actuary]:

In connection with the audit of the financial statements of [name of entity or plan] for the year ended [date], please review for consistency with the actuarial report that you prepared dated [date], the attached draft note to the financial statements and [describe other material included (e.g., required supplementary information)]. Your review should include, to the extent applicable, the computation of the annual pension cost and the net pension obligation, that we have prepared in conformity with GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employees*, and the schedules of funding progress and employer contributions that we have prepared in conformity with GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. Please forward your comments to our auditors, [name and address of auditor]. Your review should focus on, and your comments should address, all applicable information, including the following:

1. The actuarial accrued liability and the actuarial value of assets, as defined in GASB Statement Nos. 25 and 27
2. The actuarial valuation date
3. The description of the actuarial methods and significant assumptions used to determine the annual required contribution
4. The annual required contribution, interest on net pension obligation, adjustment to annual required contribution, contributions made, change in net pension obligation, and ending net pension obligation; the actuarial cost method being used; a description of the actuarial assumptions used; and the aggregate effect of any change in the method or assumption(s)
5. The schedule of funding progress, as defined in GASB Statement No. 25
6. The schedule of employer contributions, as defined in GASB Statement No. 25
7. The description of the employee group covered
8. The general description of the benefit provisions of the plan used in the actuarial valuation
9. The effective date and a description of each plan amendment, including cost-of-living adjustments, included in this actuarial valuation that was not included in the prior valuation

Please also respond to the following:

1. Were the actuarial valuation calculations performed in compliance with the parameters according to GASB Statement Nos. 25 and 27?
2. Have you been notified of a decision by the government to fully or partially terminate or close the plan? If so, please describe the effect on the plan.
3. Describe the nature of the relationship, if any, that you may have with the plan or the sponsor and that may appear to impair the objectivity of your work.
4. What is the amount of the unbilled and/or unpaid actuarial or other fees due your firm applicable to the plan year-end and payable by the plan?



5. Please supply any additional information that you believe is necessary.

Please also provide the attached additional information relating to the specific individuals contained in the census data used in performing the actuarial valuation.

Please reply to [*name of auditor*] by [*date*] so that they may complete their audit procedures on a timely basis.

Very truly yours,

[*Client Officer*]

Attachment



## AAM Section 8080

# *Common Interest Realty Associations Industry Developments—1998/99*

### In This Year's Alert . . .

- What are CIRAs?
- What industry and economic developments should an auditor be aware of when auditing a CIRA?
- What are some of the recent federal tax developments that affect CIRAs?
- What are the pros and cons of filing Form 1120H? What are the requirements for filing form 1120H?
- How should CIRAs treat environmental cleanup costs for tax purposes?
- What are the year 2000-related issues for CIRA auditors?
- What guidance exists for auditors regarding management representations?
- Which independence questions typically arise in the audits of CIRAs?
- What are the responsibilities of predecessor and successor auditors under the new auditing standard?
- Which recently issued auditing standards are relevant to CIRAs?
- What accounting issues should CIRA auditors be aware of when auditing long-term debt?
- What are the current disclosure requirements for future major repairs and replacements?
- What accounting issues relevant to real estate time-sharing transactions has the AcSEC recently discussed?
- What new accounting pronouncements have been issued that may affect CIRAs?

\* \* \* \*

## Industry and Economic Developments

### Industry Profile

#### *What are CIRAs?*

.01 The term *common interest realty association* (CIRAs) 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 kinds of CIRAs include condominiums, cooperatives, home owner's associations, and time-shares. These forms of real estate ownership—especially home owner's associations and condominiums—have grown significantly. 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 time-share developments; industrial and 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 sides 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) may be 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 Recent estimates indicate that 42 million Americans live in some 205,000 community associations. Experts forecast continued growth of between six and eight thousand new community associations per year. Growth of time-share associations also remains strong. There are over 1,200 such associations currently—over 64,000 units, and analysts expect annual growth rates of between 12 and 15 percent. Given these current statistics, demographic trends, the increasing costs of the construction and ownership of single-family homes, along with life-style preferences, industry observers expect that in the not-too-distant future, almost one-half of the country's population will live in some form of CIRA development.

## Current Environment

### *What industry and economic developments should an auditor be aware of when auditing a CIRA?*

.05 During 1998, the housing market activity was mixed. Sales of new homes (CIRA home sales comprised almost 50 percent of all sales for new homes during the year) as well as existing homes were robust in the first several months due to lower mortgage rates (the lowest levels in almost three decades) low unemployment, and strong income growth. But record levels of new housing starts were followed by a slowdown in third-quarter activity as U.S. stock markets suffered setbacks caused by global financial troubles in Asia, Russia, and Latin America. Consumer confidence fell by late summer, hampering housing activity. The Federal Reserve Board's "beige book" economic survey cited more stringent credit standards for business loans and tight labor markets as factors that could temper economic growth through 1998.

.06 The liabilities section of many CIRA balance sheets has become somewhat more complex in recent years. CIRAs commonly borrow money to fund emergency needs such as much-needed capital improvements and repairs of damaged units caused by natural disasters. Increasingly, CIRAs have used Small Business Administration (SBA) loans rather than banks as a source of long-term financing. In addition, CIRAs may be obligated for environmental remediation of their contaminated land sites or buildings under state or federal law. Appendix C of SOP 96-1, *Environmental Remediation Liabilities*, provides relevant guidance on how to audit such liabilities. A discussion on SOP 96-1 appears in the "Accounting Issues and Developments" section of this Alert. The tax treatment of environmental cleanup costs is addressed in the "Regulatory and Legislative" section herein.

.07 An annual occurrence among residential CIRAs, such as condominium associations and cooperative corporations, is the election of a new board of directors. Viewed as a positive change by some, the changeover of CIRA boards of directors may make it more difficult for auditors to obtain signatures on management representation letters. Some auditors have adopted the practice of obtaining the signatures of the managing agent (if the CIRA utilizes one) in addition to the members of the board, especially if a changeover has taken place. A further discussion of requirements under SAS No. 85, *Management Representations*, (AICPA, *Professional Standards*, vol. 1, AU sec. 333), appears in the "Audit Issues and Developments" section of this Alert and a sample representation letter appears in appendix A [paragraph .70].

## Legislative and Regulatory Developments

*What are some of the recent federal tax developments that affect CIRAs?*

.08 In auditing the financial statements of CIRAs, in particular, when considering the adequacy of the tax provision, auditors can benefit by being familiar with federal (and possibly state and local) income taxation. Such knowledge would benefit the auditor when evaluating management's consideration of applicable accounting literature, predominantly, Financial Accounting Standards Board (FASB) Statement No. 109, *Accounting for Income Taxes* (FASB, *Current Text*, vol. 1, sec. I27), as well as considering the CIRA's possible compliance with tax laws pursuant to SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). The following sections address tax issues of current and ongoing significance to CIRAs.

### Tax Treatment of Surplus Membership Assessments

.09 According to the Internal Revenue Service (IRS) Revenue Ruling 70-604, assessments by a condominium management corporation that are in excess of the amounts used for the operation of the condominium property, and that are returned to the owner-stockholders, or applied to the following year's assessments, are not taxable income to the operation (provided this procedure is approved by the members of the association).

.10 Recently, the IRS released Field Service Advice (FSA) 1998-136 in which it advised that the excess fees collected by a condominium management association could, *in some situations*, be considered taxable income. The FSA describes a situation in which a CIRA collected fees from its members but failed to refund the excess or apply it to the next year's membership fees. Instead, the excess was simply retained and carried forward until a year in which membership expenses exceeded the amount of fees collected. The CIRA recharacterized some of the excess as a return of capital, citing Revenue Ruling 70-604, 1970-2 C.B. 9 as its basis.

.11 The IRS has indicated that any amounts collected from the membership in excess of allocable expenses must be included in the CIRA's income unless, by action of the members, the excess is to be applied to the next year's expenses. Finding the CIRA's reliance on Revenue Ruling 70-604 misplaced, it noted that the ruling does not provide the authority to carry over the excess beyond the next year.

### Filing Form 1120H

*What are the pros and cons of filing Form 1120H?*

*What are the requirements for filing Form 1120H?*

.12 CIRAs that qualify may elect to be taxed under Internal Revenue Code (IRC) Section 528 utilizing form 1120H (home owner's associations) and are taxed at a 30 percent flat rate on net income in excess of one hundred dollars, generally from sources other than net member assessments. There are several benefits associated with a CIRA's election to file under IRC Section 528 including the following.

- Income from member assessments is generally exempt from tax.
- The election does not jeopardize the tax treatment to individual owners.
- The form is relatively simple to complete.
- Large CIRAs are not subject to the alternative minimum tax (AMT). (See discussion below regarding AMT and small corporations.)
- Some states provide an exemption on state income taxes.

- CIRAs need not segregate the amounts collected in advance for replacements and deferred maintenance because members' assessments are tax-exempt. (Contributions to capital retain their character regardless of that election.)

**.13** Disadvantages to filing Form 1120H include the following.

- A flat rate of 30 percent for taxable income in excess of \$100, preventing the CIRA's use of the benefits of the lower income tax brackets associated with regular corporate entities
- Inability to use net operating loss (NOL) deductions (The CIRA may not revoke its IRC Section 528 election made in previous years to obtain the tax benefits of a NOL carryback.<sup>1</sup>)
- Inability to write off organizational costs
- Inability to use the alternative tax rate imposed by IRC Section 1201(a)

**.14** The requirements for filing Form 1120H under IRC Section 528 are as follows.

- The CIRA must meet the IRS's definition of a home owners' association, which generally includes (residential) condominium associations, home owners' associations, and time-share associations.<sup>2</sup> Cooperatives corporations cannot file Form 1120H.
- With the exception of time-share associations, substantially all of the CIRA's units must be held for residential purposes.
- At least 60 percent of the CIRA's gross income for the tax year must consist of exempt function income (income related to managing and maintaining CIRA property).
- At least 90 percent of the CIRA's expenses for the tax year must be for the purpose of carrying on one or more of the exempt functions (functions related to managing and maintaining CIRA property) of a condominium or home owners' association. Time-share associations must spend at least 90 percent during the tax year for activities provided to or on behalf of their members.
- No member may profit from the CIRA's net earnings.

**.15** The CIRA's alternatives to filing Form 1120H are to file either Form 1120 (corporations) under IRC Section 277 or, in very rare situations, Form 990 (exempt organizations) under IRC Sections 501(c)4, 501(c), or 501(c)(12). An election must be made annually.

## Tax Treatment of Environmental Cleanup Costs

### *How should CIRAs treat environmental cleanup costs for tax purposes?*

**.16** CIRAs filing federal tax Form 1120 under IRC Section 277 are taxed as regular corporations, subject to the graduated corporate rates. Such CIRAs are taxed on net income from member assessments over expenditures, unless an excess of member assessments has been actually or constructively refunded to members (see the discussion on Revenue Ruling 70-604 herein), or that excess has been appropriated and segregated to restricted accounts for capital replacements. Accordingly, CIRAs may deduct expenses attributable to providing its members with services, insurance, goods, or other items of value to the extent of income derived during the year from members or transactions with members.<sup>3</sup> Because of economic performance rules under IRC Section 461(h), CIRAs should not deduct the costs associated with environmental cleanups until they are actually paid.

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<sup>1</sup> The IRS has ruled that a CIRA may revoke its IRC Section 528 election if a professional tax adviser provided inadequate advice on the benefits of the election.

<sup>2</sup> Beginning with the 1997 tax year, time-share associations that qualify under IRC Section 528 may elect to file Form 1120H. Previously, these entities were taxed as regular corporations.

<sup>3</sup> In determining the applicability of IRC Section 277 to CIRAs, the accountant should refer to applicable court cases and the IRC.

## Alternative Minimum Tax

.17 The Taxpayer Relief Act of 1997 repealed the AMT for small corporations for tax years beginning after December 31, 1997. For this purpose, small corporations are those that have annual gross receipts for the three-tax-year period (or, if shorter, the period of existence) ending with the following:

- Its first tax year beginning after December 31, 1996, are \$5 million or less
- Each later tax year (up to and including the current tax year) are \$7.5 million or less

## Audit Issues and Developments

### The Year 2000 Issue

*What are the year 2000-related issues for CIRA auditors?*

.18 The year 2000 issue relates to the inability of many electronic data processing (EDP) systems to accurately process year-date data beyond the year 1999. This is attributable to the fact that the majority of computer programs in use today were designed to store dates in the date/month/year (dd/mm/yy) format, thus allowing only two digits for each date component. So, for example, the date December 31, 1998, is stored in most computers as 12/31/98. Inherent in programming for dates in this manner is the assumption that the designation 98 refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit-year input fields will cause many computers to treat the entry 00 as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00), as January 1, 1900, and process data incorrectly, or perhaps not at all.

.19 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year 2000 ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur this year. For example, some software programs may have assigned special meanings to entries date coded as xx/xx/98 or xx/xx/99 to allow for the testing of software modifications. Therefore, actual transactions using such dates may not be processed correctly or stop functioning. Failures may also take place currently when systems perform calculations into or beyond the year 2000.

.20 Unless these year 2000 problems are remedied, significant problems relating to the integrity of all electronically processed information based on time will occur. For example, member assessments receivables may be erroneously identified as past due, interest calculations will be incorrect, and paid-up insurance policies may be considered expired. To further complicate the issue, even if a CIRA's computer software and hardware are year 2000 ready, the entity may be affected by the computer systems of vendors or third-party data processing services that have made no such modifications.

.21 CIRAs may also be affected by year 2000 problems on another level. From an operational standpoint, computer-run maintenance systems—security, fire and smoke alarms, elevators, heating and air-conditioning systems could cease running, causing dangerous and costly situations. Other systems vulnerable to the year 2000 problem may be indirectly controlled by computer by way of a chip embedded in their designs, for example, in an intercom, smoke alarm, or lighting system. CIRAs may also be at risk if their vendors and managing agents are not year 2000 ready.

.22 Auditors of CIRAs should also be aware of the risk of litigation relating to the year 2000 issue. Some clients may be uninformed about the year 2000 issue, while others may underestimate its magnitude. Those who mistakenly believe that the year 2000 issue should be addressed and resolved as part of the audit process may seek legal recourse if that outcome is not achieved. Therefore, auditors may wish to educate their clients on the year 2000 issue and its implications. Auditors may wish to incorporate these issues in the engagement

letter by outlining the responsibilities of both the client and the auditor. By advising the client and planning ahead, auditors may avoid any potential dispute with the client, while at the same time offering the opportunity of helping the client understand the seriousness of the problem and identifying resources that may be needed to address the issues.

.23 Auditors of CIRAs should be aware of the many auditing and accounting issues that arise from the year 2000 issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. A more comprehensive discussion of this topic can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

## Management Representations—New Guidance and Special Concerns

### *What guidance exists for auditors regarding management representations?*

.24 The Auditing Standards Board (ASB) issued SAS No. 85, *Management Representations*, in November 1997. SAS No. 85, which is effective for audits of financial statements for periods ending on or after June 30, 1998, provides guidance regarding written management representations to be obtained by an auditor as part of an audit performed in accordance with generally accepted auditing standards (GAAS). In conjunction with the new guidance contained in SAS No. 85, auditors are reminded of the following points.

- Auditors should inform the officers and managing agent of a CIRA about their responsibility for the financial statements and their responsibility to provide the auditor with complete and reliable financial data and information.
- If other audit evidence contradicts a management representation, an auditor is required to investigate the circumstances and consider the reliability of the representation. In such a case, an auditor should consider whether the reliance placed on other management representations is appropriate and justified.
- Clients with no accounting staff and limited knowledge of generally accepted accounting principles (GAAP) might rely, to a degree, on the auditor for the fair presentation of the financial statements. Such clients often are reluctant to make representations regarding GAAP without mentioning their reliance on the auditors.<sup>4</sup> In such a case, an auditor may suggest that the client include wording in the representation letter similar to the following.

I am responsible for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. Because of my limited expertise with generally accepted accounting principles, including financial statement disclosure, I have engaged you to advise me in fulfilling that responsibility.

.25 In addition, auditors of CIRAs should consider obtaining representations about the following matters in addition to those described in SAS No. 85:

- Disclosures based on a study of future major repairs and replacements
- The CIRA's policy for funding future major repairs and replacements
- The CIRA's policy for disposing of the excess of revenues over expenses, if any

.26 See appendix A, "Illustrative Representation Letter" [paragraph .70], for a sample management representation letter.

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<sup>4</sup> Auditors may also wish to consider providing the client an explanatory brochure published by the AICPA entitled "The Representation Letter," which can be obtained from the AICPA's Order Department at (888) 777-7077.



## Independence Issues

*Which independence questions typically arise in the audits of CIRAs?*

### *Newly Revised AICPA Independence Ruling Under Rule 101*

.27 Effective May 31, 1998, the AICPA's Professional Ethics Executive Committee issued a revised Ruling No. 31 Under Rule 101, *Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments*, of the AICPA Code of Professional Conduct (the Code). The revised ruling allows a practitioner to audit a CIRA he or she is associated with under certain conditions in which the CIRA provides services similar to those provided by a municipality. The revised ruling reads as follows.

- **Question**—A member or member's firm is associated with, or is a member of, a common interest realty association (CIRA) as the result of the ownership or lease of real estate.<sup>5</sup> Would the independence of the member or member's firm be considered to be impaired with respect to the CIRA?
- **Answer**—Yes, except independence would not be considered to be impaired with respect to the CIRA if all of the following conditions are met:
  - a. The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.
  - b. The member or member's firm's annual assessment is not material to either the member or member's firm or the CIRA's operating budgeted assessments.
  - c. The liquidation of the CIRA or the sale of common assets would not result in a distribution to the member or member's firm.
  - d. Creditors of the CIRA would not have recourse to the member or member's firm if the CIRA became insolvent.
  - e. The member or member's firm does not act or appear to act in any capacity equivalent to a member of management or as an employee for the CIRA, including membership on the board of directors or committees (excluding advisory committees as defined in Ethics Ruling No. 72 [ET section 191.144–.145]).

.28 If the member or member's firm has a relationship with a real estate developer or management company that is associated with the CIRA, see Interpretation 102-2 [AICPA, *Professional Standards*, vol. 2, ET sec. 102.03] for guidance.

### *Other Relevant Ethics Interpretations and Rulings*

.29 Auditors of CIRAs may encounter other independence issues, as discussed in the following interpretations and rulings.

- **Interpretation 101-3—Accounting Services.** Many CIRAs are small entities with few, if any, employees on staff to perform bookkeeping functions. Sometimes, employees or volunteer board members with little or no accounting knowledge maintain the books and records. CIRAs that do not use a management company may ask the auditor to perform these functions, which often include check preparation, payroll record maintenance, data processing, or financial statement preparation. Auditors should be aware of the conditions and restrictions existing under the Code, as stated in Interpretations 101-3 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05); Ethics Ruling No. 3, *Member as Signer or Cosigner of Checks* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.005–.006); and Ethics Ruling No. 4, *Payroll Preparation Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.007–.008).

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<sup>5</sup> The term *member or member's firm* is defined in Interpretation 101-9 of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.11).

- *Exposure Draft—Omnibus Proposal of Professional Ethics Division Interpretations and Rulings.* On November 16, 1998, the Professional Ethics Executive Committee (the committee) proposed a revision to Interpretation 101-3, *Accounting Services*, to address the various kinds of nonaudit services that an auditor may perform for a client. If adopted, the committee would delete several related rulings, including those noted in the preceding, and Ethics Ruling No. 55 (discussed in the following), because they are incorporated into the revised Interpretation 101-3. Auditors may download a copy of the exposure draft from the AICPA's Web site at <http://www.aicpa.org>.
- *Interpretation 101-1.B.1, Interpretation of Rule 101 and Ethics Ruling No. 55—Independence During Systems Implementation.* Interpretation 101-1.B.1 states that an auditor may not act or appear to act in any capacity equivalent to that of a member of management or of an employee. CIRAs sometimes engage an auditor to implement a new computer system during which he or she may become involved in hiring new personnel or instructing and overseeing the training of existing employees on the new system. Auditors should carefully evaluate their proposed role in the implementation of a CIRA's new system to determine whether they are complying with the requirements of Interpretation 101-1.B.1 (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02) and Ethics Ruling No. 55, *Independence During Systems Implementation Services* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.109–.110).
- *Ethics Ruling No. 52—Unpaid Fees* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.103–.104). Revised in November 1997, Ethics Ruling No. 52 provides that independence is impaired if, when the report on a client's current year is issued, billed or unbilled fees, or a note receivable arising from such fees (relating to *any* professional services previously rendered), remain unpaid for a period exceeding one year prior to the date of the report. The only exception regards fees outstanding from a client in bankruptcy.
- *Ethics Ruling No. 106—Member has Significant Influence Over an Entity That Has Significant Influence Over a Client* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.212–.213). If an auditor (who is also defined as a *member* under the Code) has significant influence over an entity that also has significant influence over the CIRA, independence is considered to be impaired.<sup>6</sup>

## Internal Control

.30 Many CIRAs tend to be small, financially unsophisticated organizations. As such, the internal control 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 may contribute to an unreliable accounting and reporting function.
- The limited resources of some CIRAs may engender informal accounting systems with inadequate control procedures.

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<sup>6</sup> For a definition of "significant influence," see Interpretation 101-9—*The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.11).

.31 If the internal control 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 as required by AICPA SAS No. 55, *Consideration of the Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78. 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 Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 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. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

## Related Parties

.32 FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. 1, sec. R36), defines *related parties* as the following:

“ . . . parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.”

In a CIRA environment, members of the organization's management, the developer, the sponsor, along with the governing board and their families, are generally considered to be related parties. Transactions occurring between the CIRA and such parties may be fairly common. For example, a sponsor or developer may provide managerial, maintenance, insurance, or other services to the CIRA.

.33 FASB Statement No. 57 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. “Related Parties” (AICPA, *Professional Standards*, vol. 1, AU sec. 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.

## A Change of Auditors

### *What are the responsibilities of predecessor and successor auditors under the new auditing standard?*

.34 SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), which superseded SAS No. 7 of the same name, provides guidance in communications between predecessor and successor auditors if a change of auditors is in process or has taken place.

.35 To begin with, SAS No. 84 redefines the terms *predecessor* and *successor* auditors. A predecessor auditor (the predecessor) is defined as an auditor who—

1. Has reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of any subsequent financial statements.

2. Has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

A successor auditor (the successor) is defined as an auditor who is considering accepting an engagement to audit financial statements but has not communicated with the predecessor auditor, as required by SAS No. 84, and to an auditor who has accepted such an engagement.

.36 SAS No. 84 cites as a necessary procedure on the part of the successor the inquiry of the predecessor. The successor, upon receiving permission from the prospective client, should make specific and reasonable inquiries of the predecessor regarding matters that will assist the successor in determining whether to accept the engagement. Though the successor may consider making any reasonable inquiry, SAS No. 84 requires that matters subject to inquiry should include the following:

- Information that might bear on the integrity of management
- Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters
- Communications to audit committees or others with equivalent authority and responsibility regarding fraud, illegal acts by clients, and internal-control-related matters
- The predecessor's understanding as to the reasons for the change of auditors

The predecessor should respond promptly and fully to the successor's reasonable inquiries. If, as a result of unusual circumstances, the predecessor decides to offer a limited response, this fact should be clearly stated. The successor should consider the implications of a limited response in deciding whether to accept the engagement.

.37 SAS No. 84 also states that the successor should request the client to authorize the predecessor to allow a review of his or her working papers. (An illustrative client consent and acknowledgment letter documenting this authorization is included in SAS No. 84). The successor's review of the predecessor's working papers may affect the nature, timing, and extent of the successor's procedures with respect to the opening balances and consistency of accounting principles. However, the work performed and the conclusions reached are solely the responsibility of the successor. The predecessor should ordinarily permit the successor to review his or her working papers, but SAS No. 84 provides that the extent, if any, to which a predecessor permits access to the working papers is a matter of judgment.

.38 SAS No. 84 also discusses audits of financial statements that have been previously audited, as well as providing communications guidance if possible misstatements are discovered in financial statements reported on by a predecessor auditor. Auditors who find themselves in the role of predecessor or successor auditors should refer to the full text of SAS No. 84 to determine the extent of their responsibilities under GAAS. SAS No. 84 became effective with respect to the acceptance of engagements after March 31, 1998.

## Special Assessments

.39 CIRAs levy special assessments for various purposes, from covering an operating deficit or litigation costs to funding major repairs and replacements. Special assessments should be reported as revenue unless they are designated for specific costs that have not yet been incurred and may therefore be deferred in accordance with paragraph 4.12 of the Guide. Auditors should also consider the proper timing and valuation of special assessments receivables, which may be collectible over a period of years.

.40 The Guide specifies that audit procedures applied to assessment revenues should include comparing total reported assessments for the period under audit with budgeted amounts and testing whether amounts assessed to individual owners have been computed in accordance with the CIRA's documents.

.41 When auditing assessments receivable, the Guide states that the auditor should design tests to provide reasonable assurance that the following have occurred.

- All assessments receivable owed to the CIRA at the balance-sheet date are recorded.
- Recorded assessments receivable represent amounts owed to the CIRA at the balance-sheet date.
- Assessments receivable are properly described and classified in the financial statements.

.42 The auditor may achieve these objectives by performing substantive tests or a combination of substantive tests and tests of control activities. One of the most widely used substantive tests for determining the existence and accuracy of receivables is confirmation of the amount receivable by direct communication with parties owing amounts to the entity being audited. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), provides guidance about the confirmation process in audits performed in accordance with GAAS. If replies to confirmation requests are not received or if the replies are not satisfactory, the auditor should obtain satisfaction about the existence and accuracy of assessment receivable balances by alternative procedures such as examining subsequent cash receipts and the existence of liens filed against units, although such liens do not assure the collectibility of assessments receivable.

.43 In addition, when auditing revenues and related receivables from special assessments, auditors may wish to consider examining the following:

- Documents supporting the board's decision to levy special assessments (minutes of meetings, contracts, or legal documents)
- The CIRA's governing documents indicating the criteria for assessing members
- The CIRA's governing documents indicating the criteria for assessing developers (owners of unsold CIRA units), and the legal responsibilities of developers to pay those assessments
- Expenditures, if any, related to special assessments (Expenses, including allocable costs such as income taxes, whether incurred or budgeted, should be directly associated with the assessment. If the assessment is for major repairs and replacements, relevant expenses include direct costs of repairing and replacing specific common property and indirect costs, such as liability insurance expense incurred during the construction period).

## New Auditing Standards

*Which recently issued auditing standards are relevant to CIRAs?*

### SAS No. 87, Restricting the Use of an Auditor's Report

.44 SAS No. 87 was issued by the ASB in September 1998 and is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, which elements to include in that report. The Statement states that an auditor should restrict use of the report if the following occur.

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or other comprehensive basis of accounting (OCBOA),
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures,
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, and not to provide assurance on the specific subject matter of the report.

.45 A complete listing of auditing pronouncements issued during 1998 can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

## Accounting Issues and Developments

### Long-Term Debt

*What accounting issues should CIRA auditors be aware of when auditing long-term debt?*

.46 As CIRAs have aged, they may have also borrowed increasing amounts of money to finance badly needed repairs and capital improvements on necessities such as boilers, elevators, and windows. CIRAs affected by a natural disaster often need to obtain funds quickly to make repairs. Depending upon the provisions of their state law and governing documents, CIRAs can borrow funds in a variety of ways. One way in which CIRAs have borrowed funds recently is through small business loans obtained from the federal government.

.47 CIRAs sometimes borrow from the Small Business Administration (SBA) on behalf of their owners to help them pay for property damages caused by natural disasters such as hurricanes, floods, and tornadoes. Because repayment of an SBA loan is the responsibility of the owners, the CIRA must maintain subsidiary receivable records, which can become complicated by various factors such as sales, early payoffs, and assumptions. Nevertheless, the benefits to CIRAs owners are manifold, as interest rates tend to be well below market rates and the loans terms can be as much as thirty years. Loan repayments begin one year after the loan is initiated. The SBA charges simple interest only on the amount actually borrowed by the owners (that is, drawn down from the CIRA's total loan proceeds). Accordingly, the CIRA should record a payable (and corresponding owner receivable) for the amount assessed to the owners for the loan repayment. The notes to the financial statements should adequately disclose the loan terms.

### SOP 96-1, Environmental Remediation Liabilities

.48 CIRAs may become liable, under state or federal laws, for environmental cleanup costs. Using the criteria of FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59), as a starting point, auditors may determine whether a liability should be accrued and disclosed, disclosed only, or not addressed at all. SOP 96-1, *Environmental Remediation Liabilities*, sets requirements for recognizing, measuring, and accruing these liabilities and for related disclosures.

.49 Appendix C entitled "Auditing Environmental Remediation Liabilities" of SOP 96-1 provides specific guidance to auditors on planning, performing, and reporting on an audit of financial statements in accordance with GAAP as it relates to auditing environmental remediation liabilities arising from Superfund laws, the corrective action provisions of the Resource Conservation and Recovery Act of 1976, and other analogous federal, state, and non-United States laws and regulations, including the following:

- Audit planning and objectives
  - Understanding the business
  - Audit objectives
  - Assessing audit risk
- Substantive audit procedures
  - Reviewing and testing the process used by management to develop the estimate
  - Developing an independent expectation of the estimate
  - Using the work of a specialist
  - Auditing potential recoveries
  - Inquiries of a client's lawyer
  - Client representations

- Assessing disclosures
- Evaluating audit test results
- Reporting
  - Departures from GAAP
  - Scope limitations
  - Making reference to a specialist
  - Accounting changes
  - Communication with audit committees

## Funding for Future Major Repairs and Replacements

*What are the current disclosure requirements for future major repairs and replacements?*

.50 Currently, the Guide requires all CIRAs to disclose information in their financial statements about funding for future major repairs and replacements (paragraph 4.27), including the following:

- Legal requirements (via state law or the CIRA's governing documents) to accumulate funds for future major repairs and replacements
- A description of the CIRA's funding policy and a statement as to whether the CIRA is in compliance with the above-mentioned legal requirements or CIRA policy
- A statement that funds, if any, are being accumulated on the basis of estimates that may materially differ from actual expenditures
- Amounts assessed in the current period for major repairs and replacements
- A statement as to whether a study was conducted to estimate the remaining useful lives of common property and the costs of future major repairs and replacements

The Guide also states that CIRAs that fund future major repairs and replacements by special assessments or borrowings as needs occur should disclose that information as well.

.51 Some CIRAs elect to exclude the preceding disclosures from their financial statements. Under such circumstances, auditors are required by "Required Supplementary Information" (AICPA, *Professional Standards*, vol. 1, AU sec. 558), to add an explanatory paragraph to the audit report indicating the omission.

## Proposed SOP Regarding Real Estate Time-Sharing Transactions

*What accounting issues relevant to real estate time-sharing transactions has the AcSEC recently discussed?*

.52 As a result of a lack of guidance specific to real estate time-sharing transactions, and resulting diversity in practice, the Accounting Standards Executive Committee (AcSEC) of the AICPA added a project to its agenda to propose an SOP that addresses issues related to the development of time shares, including the following questions:

- Which revenue recognition method should be used?
- How should allowances for uncollectible receivables be determined?
- What kinds of selling costs may be deferred?

.53 As of its October 1998 meeting, AcSEC proposed that right-to-use transactions, in which title does not pass, should be accounted for similar to operating leases rather than as sales. AcSEC considered the

retail-land-sales (RLS) and the other-than-retail-sales (OTRLS) models of FASB Statement No. 66, *Accounting for Sales of Real Estate* (FASB, *Current Text*, vol. 3, sec. Re1), and an alternative model, that would be developed, as the basic model to be adopted for time-sharing transactions. AcSEC agreed to develop an alternative to the RLS and OTRLS models, that would more closely fit the nature and substance of time-sharing transactions. This approach would necessitate an amendment to FASB Statement No. 66 to exclude time-sharing transactions from its scope and, as this approach was not contemplated in the original prospectus. A new or amended prospectus will be deliberated by FASB. AcSEC also discussed the issue of expensing versus deferring costs incurred by the seller of the time-sharing interest and also requested that the task force clarify the rights, responsibilities, and relationships among developers, purchasers, and exchange companies. AcSEC plans to discuss these issues further at its January 1999 meeting.

.54 Although not directly related to CIRAs, some auditors of CIRAs may have an interest in these matters. Further information can be obtained from the AICPA's Web site at <http://www.aicpa.org>.

## New FASB Pronouncements

*What new accounting pronouncements have been issued that may affect CIRAs?*

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- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (FASB, *Current Text*, vol. 1, secs. P16, P40) was issued in February 1998, and revises disclosure requirements for employers' pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. The new Statement standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable and eliminates certain disclosures formerly required under FASB Statement Nos. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16); 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Plans and Termination of Benefits* (FASB, *Current Text*, vol. 1, sec. P16); and 106, *Employers' Accounting for Postretirement Benefits Other than Pensions* (FASB, *Current Text*, vol. 1, sec. P40). FASB Statement No. 132 requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis. The effective date is fiscal years beginning after December 15, 1997, with early application encouraged.
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, was issued in June 1998, and establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. FASB Statement No. 133 supersedes FASB Statement Nos. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk, and Financial Instruments with Concentrations of Credit Risk*, and 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. It carries forward the requirement under FASB Statement No. 119 to disclose the objectives, context, and strategies for holding and issuing derivatives. Qualitative disclosures describing the overall risk management profile are encouraged, but not required. FASB Statement No. 133 eliminates the requirement to disclose the average fair value of derivatives held for trading purposes. It also eliminates the requirement under both FASB Statement Nos. 105 and 119 to disclose the face or contract amount of derivatives held at the balance-sheet date although these amounts might be disclosed in order to present details about the investments. In addition, requirements under FASB Statement No. 105 to disclose the nature and terms of financial instruments with off-balance-sheet risk and the cash-flow requirements associated with them are also eliminated. The effective date is fiscal years beginning on or after June 15, 1999, with early adoption permitted.
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, was issued in October 1998. It is unlikely that this Statement will impact CIRAs as it relates primarily to mortgage banking enterprises.



.56 For a comprehensive summary of accounting pronouncements issued this year, see the *Audit Risk Alert—1998/99* [AAM section 8010].

## AICPA Services

### Order Information

.57 To order AICPA products, call (888) 777-7077 (menu selection #1); write AICPA Order Department, P.O. Box 2209, Jersey City, NJ 07303-2209; or fax (800) 362-5066. Prices do not include shipping and handling. For best results call Monday through Friday between 8:30 A.M. and 7:30 P.M. Eastern time. Obtaining product information and placing online orders can be done at the AICPA's Web site ([www.aicpa.org](http://www.aicpa.org)).

### Audit and Accounting Guide

.58 The AICPA Audit and Accounting Guide *Common Interest Realty Associations*, 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 (888) 777-7077 or faxing a request to (800) 362-5066.

### CIRA Financial Reporting Checklist

.59 The AICPA's Accounting and Auditing Publications Division has published a revised version of the Disclosure Checklist and Illustrative Financial Statements *Common Interest Realty Associations*, a nonauthoritative practice aid for preparers or reviewers of financial statements of CIRAs. Copies may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066.

### Accounting and Auditing Technical Hotline

.60 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

### Ethics Hotline

.61 Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

### World Wide Web Site

.62 "AICPA Online," the Institute's Web site ([www.aicpa.org](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. The Web site includes "In Our Opinion," the newsletter of the AICPA Audit and Attest Standards Team. The newsletter provides valuable and timely information on technical activities and developments in auditing and attestation standard setting.

## References for Additional Guidance

.63 Further information on matters addressed in this 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 the user 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 and Web sites 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 This Audit Risk Alert replaces *Common Interest Realty Association Industry Developments—1997/98*.

\* \* \* \*

.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—1998/99* [AAM section 8010] and *Compilation and Review Alert—1998/99* [AAM section 8015] which may be obtained by calling the AICPA Order Department.

.69 This Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may email these comments to [Rdurak@aicpa.org](mailto:Rdurak@aicpa.org) or write to:

Robert Durak  
AICPA  
Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

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## Appendix A

### Illustrative Representation Letter

*[To be prepared on the CIRA's or managing agent's letterhead]*

*[Date]*

To *[Independent Auditor]*

We are providing this letter in connection with your audit of the balance sheet and the related statement of revenues, expenses, and changes in fund balances, and cash flows of XYZ Condominium Association as of December 31, 19X2, and for the year then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of XYZ Condominium Association in conformity with generally accepted accounting principles. We confirm that we are responsible for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

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

We confirm, to the best of our knowledge and belief, *[as of (date of auditor's report)]*, the following representations made to you during your audit.

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We are responsible for the fair presentation of the information about future major repairs and replacements in the supplementary information accompanying the financial statements.
3. We have made available to you all:
  - a. Financial records and related data
  - b. Minutes of the meetings of directors and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared
4. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
5. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
6. There has been no:
  - a. Fraud involving management or employees who have significant roles in internal control
  - b. Fraud involving others that could have a material effect on the financial statements
7. The Association has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
8. The following have been properly recorded or disclosed in the financial statements:

- a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties
  - b. Guarantees, whether written or oral, under which the Association is contingently liable
  - c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [Significant estimates are estimates at the balance-sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]
9. There are no:
- a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
  - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.<sup>7</sup>
  - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
10. The Association has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
11. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
- [Note that additional representations that are unique to the CIRA could be added here. Examples might include items 12 and 13.]
12. The Board of directors is collecting funds for major repairs and replacements in conformity with the Association's policy to fund for those needs based on a study conducted in November 19X2. The board of directors believes that the funds will adequately provide for future major repairs and replacements.
13. The board of directors has allocated the excess of the association's revenues over its expenses during the current year to the fund for future major repairs and replacements.

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

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[Name of Chief Executive Officer and Title]<sup>8</sup>

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[Name of Chief Financial Officer and Title]<sup>9</sup>

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<sup>7</sup> In the circumstance discussed in footnote 7 of SAS No. 85, this representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

<sup>8</sup> Management representatives acting as signators to the letter might include officers of the CIRA and the managing agent, if any.

<sup>9</sup> Management representatives acting as signators to the letter might include officers of the CIRA and the managing agent, if any.

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## Appendix B

### The Internet—An Auditor's Research Tool

Some Web sites that may provide valuable information to auditors are listed in the following table:

<i>Name of Web Site</i>	<i>Content</i>	<i>Internet Address</i>
American Institute of CPAs	Summaries of recent auditing and other professional standards as well as other AICPA activities	<a href="http://www.aicpa.org">http://www.aicpa.org</a>
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	<a href="http://www.fasb.org">http://www.fasb.org</a>
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	<a href="http://www.gasb.org">http://www.gasb.org</a>
General Accounting Office	GAO policy and guidance materials, reports on federal agency major rules	<a href="http://www.gao.gov">http://www.gao.gov</a>
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	<a href="http://www.electronicaccountant.com">http://www.electronicaccountant.com</a>
AuditNet	Electronic communications among audit professionals	<a href="http://www.cowan.edu.au/mra/home.htm">http://www.cowan.edu.au/mra/home.htm</a>
CPAnet	Links to other Web sites of interest to CPAs	<a href="http://www.cpalinks.com/">http://www.cpalinks.com/</a>
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	<a href="http://www.tetranet.net/users/gaostl/guide.htm">http://www.tetranet.net/users/gaostl/guide.htm</a>
Accountant's Home Page	Resources for accountants and financial and business professionals	<a href="http://www.computercpa.com/">http://www.computercpa.com/</a>
Double Entries	A weekly newsletter on accounting and auditing around the world	<a href="http://www.csu.edu.au/lists.anet/ADBLE-L/index.html">http://www.csu.edu.au/lists.anet/ADBLE-L/index.html</a>
U.S. Tax Code Online	A complete text of the U.S. Tax Code	<a href="http://www.fourmilab.ch/ustax/ustax.html">http://www.fourmilab.ch/ustax/ustax.html</a>
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory	<a href="http://www.fsforum.com">http://www.fsforum.com</a>
Cybersolve	Online financial calculators such as ratio and break even analysis	<a href="http://www.cybersolve.com/tools1.html">http://www.cybersolve.com/tools1.html</a>
FedWorld. Gov	U.S. Department of commerce sponsored site providing access to government publications	<a href="http://www.fedworld.com">http://www.fedworld.com</a>
Hoovers Online	Online information on various companies and industries	<a href="http://www.hoovers.com">http://www.hoovers.com</a>
Vision Project	Information on the profession's vision project	<a href="http://www.cpavision.org/horizon">http://www.cpavision.org/horizon</a>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.kentis.com/ib.html">http://www.kentis.com/ib.html</a>

## Information Sources

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Organization	General Information	Fax Services	Internet	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (800) 362-5066	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)
Community Associations Institute	1630 Duke Street Alexandria, VA 22314 (703) 548-8600		www.caionline.org	
National Association of Housing Cooperatives	1614 King Street Alexandria, VA 22314 (703) 549-5201			

[The next page is 8247.]

# AAM Section 8090

## *Construction Contractors Industry Developments—1998/99*

### In This Year's Alert . . .

- How is the construction industry performing?
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### Industry and Economic Developments

#### *How is the construction industry performing?*

.01 The construction industry can be divided into the following three segments:

- *Building Construction.* This group includes contractors engaged in the building of residential, commercial, industrial, and other buildings.
- *Heavy Construction.* This group includes contractors engaged in *nonbuilding* construction such as highways, bridges, dams, railroads, sidewalks, airport runways, and other projects.
- *Special Trade.* This group includes contractors who specialize in work such as painting, electrical, roofing, plumbing, carpentry, air-conditioning, and other specialties.

(Nonbuilding construction generally consists of long-term, publicly financed projects that are typically less sensitive to economic conditions than other segments of the industry.)

.02 The construction industry is experiencing a boom period. The robust economy, low inflation, and low interest rates have fueled construction spending across the nation. Moreover, a recently enacted \$217 billion highway construction bill, and planned cash outlays by local governments to construct and improve schools and other institutions should contribute to the continued growth of the construction industry. This positive growth is expected to continue for the next few years. However, the value of new construction contracts has declined recently, and there are signs that the current boom may be receding. A shortage of skilled laborers, rising prices for construction material, economic turmoil around the world, uncertainty in the stock market, and the housing cycle itself are threatening to slow down construction growth.

## Home Building

.03 The home building sector of the industry has been particularly strong. The economic growth that the country has been experiencing includes favorable conditions such as low unemployment, low interest rates, high levels of consumer confidence, rising wages, and large increases in the value of investments and savings. These factors contribute to a heavy demand for home construction and remodeling. Indeed, housing construction has reached record-breaking levels. In many areas, contractors have so much work that they are turning away business. What's more, the strong home construction conditions are generally found throughout most regions of the nation, and encompass most segments of home building, including single-family and multifamily homes.

.04 Whether the strong growth in home building can continue is difficult to determine. A slowdown in the rate of growth is expected. In fact, the pace of residential building and new home sales has retreated recently.

.05 In addition to the high volume of home building business, construction contractors are seeing favorable increases in their profit margins. These increases are largely the result of the intense demand for new homes and improved efficiency in the way contractors conduct their business.

.06 The construction of nonresidential buildings is also robust. Organizations are spending capital to create buildings such as offices, plants, warehouses, hotels, schools, hospitals, and all sorts of nonresidential structures. The construction growth in these areas is attributable to many factors, primary among them the strength of the overall economy, which encourages businesses to expand operations, and low interest rates, which encourage capital investments.

.07 Like home building, nonresidential construction has also been exhibiting signs of a slower growth rate, however. Growth in office, hotel, store and other nonresidential building construction has abated lately. In particular, the building of manufacturing plants has slowed considerably, due to the uncertain future for U.S. manufacturers and exporters, in light of the current economic troubles in Asia and in other countries.

.08 The Bureau of Statistics, at the U.S. Department of Commerce, has compiled the following information relating to new construction put in place:

**Tables of New Construction Put in Place (Billions of Dollars—Seasonally Adjusted Annual Rate)**

	<i>August 1998</i>	<i>August 1997</i>
Total Construction	651.6	623.4
Private construction	503.7	475.5
Public construction	147.9	147.9

	<i>August 1998</i>	<i>August 1997</i>
Residential buildings	296.2	263.5

(Continued)



	August 1998	August 1997
Non-residential Buildings	164.2	170.1
Industrial	28.6	33.4
Office	36.8	34.1
Hotels, motels	13.8	13.4
Other commercial	47.0	51.4
Religious	6.4	5.7
Educational	8.8	8.5
Hospital and institutional	13.6	13.9
Miscellaneous Buildings	9.2	9.7

	August 1998	August 1997
Public Construction	147.9	147.9
Housing and redevelopment	5.2	4.9
Industrial	1.1	1.0
Educational	27.3	26.7
Hospital	4.2	5.1
Other public buildings	27.2	25.5
Highways and streets	44.8	45.9
Military facilities	2.9	2.8
Conservation and development	5.4	5.5
Sewer systems	10.7	10.1
Water supply facilities	6.7	6.1
Miscellaneous public	12.4	14.3

.09 Auditors should consider the overall performance of the industry in which their construction clients operate, as it relates to their audits. Knowledge of industry conditions may influence audit planning and will better equip auditors to make decisions on their engagements and help them better advise their clients. Certain issues discussed below stem from the current conditions of the construction industry discussed above. For a more comprehensive overview of the performance of the construction industry, auditors should consult the "References for Additional Guidance" section at the end of this Alert.

## Audit Issues and Developments

### Revenue Recognition

*What are some matters an auditor should remember about revenue recognition at construction contractors?*

.10 The year 1998 has seen more than its share of high-profile incidents of improper revenue recognition. Given the numerous revenue recognition problems and the attendant publicity, auditors would do well to strengthen their focus on revenue recognition procedures at their clients.

.11 The determination of the point or points at which revenue should be recognized as earned is a major accounting issue for construction contractors and an area of significant risk for auditors. Accounting for construction contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods. This involves the considerable use of estimates in determining revenue and assigning it to accounting periods. The process is complicated by the

need to evaluate continually the uncertainties inherent in the performance of contracts and by the need to rely on estimates of revenue.

.12 Generally, revenue recognition procedures at construction contractors are performed at the individual contract level. The contract is the profit center where revenue recognition is determined. Basically, two generally accepted methods of accounting for contracts are available to construction contractors: the percentage-of-completion method and the completed contract method. The primary source of authority for these methods is AICPA Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, and the AICPA Audit and Accounting Guide *Construction Contractors*. Auditors should understand these accounting methods and determine that they are properly applied by their construction clients. SOP 81-1 and the Audit and Accounting Guide *Construction Contractors* can be obtained by calling the AICPA Order Department at 1-(888)-777-7077.

### ***Percentage-of-Completion Method***

.13 The most widely used method of accounting for contracts is the percentage-of-completion method. One of the most important components of the percentage-of-completion method is the measurement of the progress of the job. In order to measure progress towards completion, input or output measures can be used. Input measures are defined in terms of efforts devoted to a contract, including methods based on costs and on efforts expended, whereas output measures are based on results achieved such as units produced, units delivered, contract milestones, and value added. Although the use of input and output measures are both allowed, output measures are in general better gauges of progress. Frequently, output measures cannot be reasonably determined and, as a result, input measures are used.

.14 When selecting a basis for measuring progress, weight should be given to all elements of a contractor's work, including the following:

- Design of the project
- Obtaining the necessary labor, materials, supplies, and equipment and mobilizing them at the construction site
- Managing the resources to complete the project
- Demobilizing the resources from the construction site

### ***Completed Contract Method***

.15 The second method for recognizing revenue on construction contracts is the completed contract method. This method should only be used in any of the following instances:

1. When it does not vary materially from the percentage-of-completion method (for example, for short-term contracts)
2. If reasonably dependable estimates of costs, and so on, cannot be made
3. If there are inherent hazards (for example, contracts exposed to condemnation) that cause estimating to be undependable

The completed contract method is sometimes used by contractors that primarily have short-term contracts.

.16 If the completed contract method is used, all revenues on a contract are deferred until the contract is completed. Once a contract is substantially complete, all of the revenue on the contract is recognized. Determining whether a contract is substantially complete is a matter of judgment. Generally, a contract is considered substantially complete when the remaining costs, as well as the potential risks on a contract, are insignificant. Regardless of the criteria used for determining substantial completion, they should be consistently applied.

## ***Auditing Estimates***

.17 Auditing revenue recognition at construction contractors should be performed during the final phase of the audit, after adjustments such as changes to contract billings and costs are made. As mentioned above, revenue recognition for construction contractors involves the considerable use of estimates.

.18 Auditors should be particularly alert to the need for revisions to estimates of total contract revenue, and whether the revisions made by management are appropriate. Revisions made to revenue estimates are considered changes in accounting estimates as defined in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes* (FASB, *Current Text*, vol. 1, sec. A06). Opinion 20 has been interpreted to permit the following two alternative methods of accounting for changes in accounting estimates:

1. *Cumulative Catch-up.* Account for the change in estimate in the period of change so that the balance sheet at the end of the period of change and the accounting in subsequent periods are as they would have been if the revised estimate had been the original estimate.
2. *Reallocation.* Account for the effect of the change ratably over the period of change in estimate and subsequent periods.

Although both methods are used in practice to account for changes in estimates of total revenue, total costs, or extent of progress under the percentage-of-completion method, the cumulative catch-up method is more widely used. Accordingly, to narrow the areas of differences in practice, such changes should be accounted for by the cumulative catch-up method.

.19 When auditing estimates and their revisions, auditors should be familiar with Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements.

.20 Presented below are practice tips for auditing estimates:

- In evaluating the reasonableness of estimates, consider your history with the client, the original bid estimates for the contract, the differences between the contract amount awarded and the next lowest bidder, reasons for any large differences, and management's explanation for profit fluctuations differing from expected amounts.
- Be alert for hidden assumptions. Just because something is the same as last year does not mean it is supposed to be the same as last year.
- Post-balance-sheet events are a great source to either corroborate or contradict assumptions used in an estimate.
- Be especially wary of any contracts in which little or no estimated profit is projected. If this occurs, compare original bid documents to current total cost projections, determine the status of any pending change orders, and consult with project managers, engineers, estimators, or outside specialists as necessary (see SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), for guidance on using specialists) before forming an opinion as to the adequacy of estimated total contract costs and the need to record potential losses.
- Remember your overall objective. You are not trying to conclude that any one given outcome is expected. You are trying to determine whether certain assumptions are supportable and provide a reasonable basis for the estimate.

## **Auditing Concerns During Prosperous Times**

*What are some risks that may develop during a prosperous business period?*

.21 As mentioned earlier, the construction industry, in general, is experiencing a period of growth and prosperity. Nevertheless, an auditor should not become complacent during these good times and should be alert to the existence of risk during a prosperous economic period.

.22 Auditors should be alert to the potential for management to use overly optimistic assumptions when developing estimates under favorable economic conditions. If economic conditions change significantly for the worse, such overly optimistic assumptions, unless revised, may result in material misstatements. As mentioned in the "Revenue Recognition" section of this Alert, when auditing estimates and their revisions, auditors should understand the requirements of SAS No. 57. The guidelines in SAS No. 57 will help auditors properly assess the reasonableness of estimates and their revisions.

.23 Job site visits can assist the auditor in assessing the reasonableness of 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 that may have accounting implications. An on-site visit can help auditors 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.
- 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 complicated, the auditor should consider engaging the services of a specialist.

Finally, although business conditions are currently positive, a change in economic conditions in the near future 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 during better times. In this circumstance, the auditor's assessment of the proper valuation of receivables from such customers may take on increased importance. Auditors may consider applying procedures such as reviewing subsequent cash receipts, assessing customer financial viability and past payment performance, and evaluating the adequacy of allowances for doubtful accounts.

## The Third Millennium Bug

*What is the year 2000 issue, and how will it affect the construction industry?*

.24 The inability of most computer programs to distinguish the year 1900 AD from the year 2000 AD poses substantial risks to construction contractors. The majority of computer operating systems and programs currently in use have six-digit date fields (YY/MM/DD), which represent, for example, December 31, 1999, by 99/12/31. The six-digit field, with only two digits for the year, is the basis for all date-related calculations within most computer systems today, particularly mainframes. The fundamental problem posed for these systems by the arrival of the year 2000 is that they have no way of expressing a date past year-end 1999; 00/01/01 will be interpreted by them as January 1, 1900.

.25 The year 2000 problem is pervasive and complex. Virtually every organization will have its computing operations affected in some way by the rollover of the two-digit year value to 00. Construction contractors, subcontractors, suppliers, lenders, and others with whom the contractor does business need to address the risks associated with the coming millennium. Assuring that computer systems and applications are year 2000 compliant presents a complex managerial and technological challenge for most companies. Achieving year 2000 compliance in mission-critical systems is essential for maintaining the quality and continuity of the business.

.26 The year 2000 is not only an information systems issue, but an enterprise-wide challenge that must be addressed at the very highest level of a construction contractor. Unlike other industries, such as financial institutions, the construction industry is generally behind in preparing for the year 2000. Senior management

and the board of directors should actively manage efforts to plan, allocate resources, and monitor progress to correct year 2000 problems.

.27 Essentially, any system applications or processes at the construction contractor that are date-sensitive will be affected by the millennium bug. If data entered into those applications and processes include dates beyond 1999, problems may very well arise, which can disrupt operations and create inaccurate financial results. Applications and processes that may be affected include the following:

- Job scheduling
- Job estimating
- Job costing and budgeting
- Purchasing
- Depreciation and amortization
- Payroll
- Accounts receivable
- Accounts payable
- Tracking of license, insurance, and permit expirations

Management of construction companies will need to address possible year 2000 issues with these applications and processes, and other systems.

### ***Auditing Issues***

.28 First, it must be understood that it is the responsibility of an entity's management—not of the auditor—to assess and remedy the effects of the year 2000 on an entity's systems. Under generally accepted auditing standards (GAAS), 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the year 2000 or by some other cause.

.29 Many auditing and accounting issues exist related to the year 2000 issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. These issues are fully discussed in the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. Auditors should be aware of these auditing and accounting issues and should understand the various auditing and accounting guidance that has been issued on the year 2000 issue. The general *Audit Risk Alert—1998/99* [AAM section 8010] can be obtained by calling the AICPA Order Department at 1-(888)-777-7077.

### **Misappropriating Construction Equipment**

*Should auditors be concerned with the risk of misappropriation of heavy equipment?*

.30 The misappropriation of heavy construction equipment is a growing problem in the construction industry and, in some areas of the country, has reached unprecedented heights. Although many people might assume that a massive, yellow bulldozer is almost impossible to steal, the fact is that many thieves simply walk onto construction sites and take bulldozers, loaders, excavators, backhoes, and other heavy construction pieces and equipment.

.31 A primary reason for the easy misappropriation of heavy assets is that manufacturers design the vehicles to operate with a single universal key, which can be found almost everywhere. In addition, manu-

facturers have improved construction equipment, making these vehicles much easier to drive and operate. Thus, it does not take unusual skill to start and drive many of the heavy pieces. Another significant factor contributing to the ease of stealing construction pieces is the lack of adequate paperwork required to purchase construction equipment, therefore making it more difficult to trace. Thieves often pretend to be construction workers moving heavy construction pieces, and are unnoticed.

.32 Finally, the robust performance of the construction industry is fueling the rise in the theft of heavy construction equipment, by creating a great demand for heavy equipment such as bulldozers and tractors. Stealing or buying the stolen goods is the quickest and least expensive way to get heavy equipment. Only a small percentage of stolen equipment is ever recovered, and big profits can be made in stealing and selling the pieces.

### ***Auditing Concerns***

.33 An auditor would be concerned if there is a risk that the theft of heavy equipment causes the construction contractor's financial statements to be materially misstated. Auditors should understand and apply the requirements of SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). SAS No. 82 is the primary guidance on auditing responsibilities concerning the risk of material misstatement of the financial statements due to fraud arising from misappropriation of assets. (SAS No. 82 also provides guidance on fraud related to fraudulent financial reporting.) Misappropriation of assets includes the theft of heavy construction equipment.

.34 As stated in SAS No. 82, auditors should consider fraud risk factors that relate to misstatements arising from misappropriation of assets in each of the following categories:

1. *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.
2. *Controls.* These involve the lack of controls designed to prevent or detect misappropriation of assets.

.35 At first glance, heavy construction equipment may not appear susceptible to misappropriation. But a consideration of the facts mentioned above (for example, the demand for the equipment and the ease of access) may lead an auditor to conclude that there are risk factors present that may make the heavy equipment susceptible to theft. Presented below are some risk factors relating to misstatements arising from misappropriation of heavy equipment assets. The following risk factors do not necessarily indicate the existence of fraud; however, they have been observed in circumstances where misappropriation of assets have occurred:

- Material job site inventory
- Remote operations causing management oversight difficulties
- A lack of management oversight, such as monitoring job site activities
- Poor physical safeguards at job sites and over equipment
- Inadequate record keeping with respect to heavy equipment

.36 If a risk of material misstatement due to fraud relating to misappropriation of heavy equipment is identified, the audit response should be directed toward the account balance, and the scope of the work should be linked to the specific information about the misappropriation risk that has been identified. For example, obtaining an understanding of the control activities related to the prevention and detection of the theft of heavy equipment and testing the operating effectiveness of such controls may be warranted. In certain circumstances, physical inspection of the heavy pieces at or near year-end may be appropriate.

.37 Auditors should read the AICPA's Practice Aid, entitled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, to better understand and implement the requirements of SAS No. 82. This publication can be obtained by calling the AICPA Order Department at 1-(888)-777-7077, and requesting Product No. 008883.

## Global Economic Crisis

*What, briefly, are these global economic problems all about and how do they affect construction contractors?*

.38 There is a global financial and economic crisis occurring that is shaping up to be one of the most exacting economic shocks of the century. Beginning in the foreign exchange markets of Asia and mushrooming into the banking sector, this crisis has spread to Russia and Latin America, and is threatening to destabilize the European and American economies. A global recession may result, with serious implications for U.S. companies and Americans.

.39 Construction contractors will be affected by the global economic turmoil in three main ways. First, contracts to perform work on overseas projects, located in countries experiencing economic difficulties, may be delayed or canceled. Second, Asian contractors desperate for work, and contractors from other areas of the globe suffering similarly harsh economic times, may compete for work in the United States, thus increasing the competition within the construction industry. Third, businesses and people in the United States adversely affected by the global crisis may spend less money on construction projects. Businesses may curtail their expansion plans, and people may put off remodeling projects or home purchases, if the financial problems affecting the global economy cause economic conditions in America to take a turn for the worse.

### *Auditing Issues*

.40 Auditors should be aware of their responsibilities pursuant to the guidance set forth under SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). SAS No. 22 requires, in part, that in planning the audit, the auditor should consider matters affecting the industry in which the entity operates, including current economic conditions. As such, auditors should assess the potential impact that the global economic crisis may have on their construction clients when considering the nature, timing, and extent of work to be performed. Factors to be considered in making the assessment might include the following:

- Whether Asian and other affected foreign businesses are among the contractor's major customers or suppliers
- The extent to which the client competes with low-priced foreign construction firms
- The extent to which a contractor's major customers are dependent upon foreign trade, or suffer economic setbacks due to the global crisis. For example, a contractor may service a concentrated base of customers who are employed by or are dependent upon one major corporation in the area. If that corporation is severely affected by the global economic crisis, it may need to lay off employees, cut back wage increases, and take other austerity measures. These actions could affect the ability and desire of the company's employees, and others dependent upon the corporation, to buy new homes, remodel existing homes, or purchase other kinds of construction work. Consequently, the contractor may lose substantial amounts of work and may not be able to collect on work already performed.

If it appears likely that the Asian crisis may have an impact on any aspect of the contractor's operations, consideration should be given to the possible audit and accounting issues that might arise. Examples include some of the following:

- Auditors should consider whether management has appropriately accounted for and made all required disclosures relating to foreign currency translation and transactions arising from the translation of asset and liability positions, and revenue and expense transactions in currencies other than the U.S. dollar, pursuant to Financial Accounting Standards Board (FASB) Statement No. 52, *Foreign Currency* (FASB, *Current Text*, vol. 1, sec. F60).

- The global crisis may also result in a greater number of risks and uncertainties for some contractors, particularly with regard to current vulnerability due to certain concentrations. Auditors should consider whether management has appropriately evaluated all such risks and uncertainties and made the necessary disclosures pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition, auditors should also evaluate management's consideration of related contingencies arising from the global crisis, pursuant to FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59).
- The collectibility of amounts due from troubled foreign entities or from people and entities suffering financial problems due to the global crisis may be called into question. Auditors should consider whether management has properly valued these receivables.
- For a number of contractors, the economic impact of the global crisis may engender fraud risk factors that suggest an increased possibility of misstatements arising from fraudulent financial reporting. For example, to offset losses incurred from a slowdown in construction projects to Asian customers or local customers affected by the financial crisis, a contractor may resort to the inappropriate acceleration of revenue recognition or the improper deferral of expenses. SAS No. 82 sets forth the auditor's responsibilities to detect fraud in a financial statement audit.
- Going-concern issues may arise for those construction entities with significant reliance on people and businesses adversely affected by the economic crisis. In such circumstances, auditors should consider the guidance set forth under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341).

These examples call attention to some of the possible auditing and accounting implications of the global economic crisis, but should not be viewed as an exhaustive list of all the issues that might arise. Auditors should continue to monitor the crisis and carefully assess its impact on their clients, considering all relevant facts and circumstances.

## Skilled Labor Shortage

### *What should concern an auditor about the shortage of skilled construction labor?*

.41 The construction industry is experiencing a serious shortage of skilled workers, including craftsmen, engineers, bricklayers, welders, electricians, insulators, and others. This shortage is to be found across the country, but it is most severe in the Southeast and Southwest. This lack of skilled workers is considered by many to be the most serious issue confronting the industry.

.42 A lack of qualified employees, or the existence of unqualified employees, at a construction contractor can be a concern to an auditor if such labor problems have the potential to affect the future earnings and financial health of the contractor. Also, a lack of skilled labor, or the hiring of employees lacking adequate skills (due to the labor shortage), may increase the construction entity's exposure to contract disputes, litigation, claims and liabilities resulting from poor workmanship or uncompleted projects.

.43 Auditors should be alert to the labor shortage problem in the industry and determine whether that problem will have a significant effect on the entity's business. Auditors should obtain reasonable assurance that matters involving alleged breach of contract, liabilities related to faulty construction work, and litigation or claims related to contract disputes have been identified, accounted for, and disclosed. The procedures an auditor follows to satisfy himself with respect to such potential liabilities will depend upon the circumstances of the individual engagement and the judgment of the auditor.

.44 Since matters such as breach of contract and liabilities stemming from faulty or uncompleted construction work are matters within the direct knowledge and, often, the control of management of a contractor, management is the primary source of information about such matters. Depending upon the judgment of the auditor and the planning and risk assessment decisions that have been reached, the auditor



may want to include the following procedures in his efforts to identify and audit breach of contract matters, liabilities related to faulty or uncompleted construction work, contract disputes, litigation, and other claims:

- Discuss with management the existence, if any, of a labor shortage problem at the contractor and any significant problems with the quality of the employees working on the company's construction projects. Perform other procedures, as might be deemed necessary, to determine whether a skilled labor shortage problem exists at the client. Determine whether any problems identified may pose a sufficient risk that additional audit procedures are necessary.
- Inquire of management about unrecorded liabilities, loss contingencies, claims regarding breach of contract, and faulty or uncompleted work.
- Read the minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited.
- Read contracts, correspondence and invoices from lawyers, and similar documents.
- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance-sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel, and obtain assurances from management, in writing, that they have disclosed all such matters required to be disclosed by FASB Statement No. 5.
- Obtain a written confirmation from management 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.
- Request management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.45 Auditors should be familiar with the guidance contained in SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337), FASB Statement No. 5 referred to above, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

## Equipment Leasing

*What accounting guidance applies to lease arrangements, and what are some auditing steps that an auditor should consider when examining leases?*

.46 Construction contractors are choosing more often to lease equipment instead of buying it. There are many benefits to leasing, including the avoidance of large cash outlays, lower monthly payments, and protection against obsolete equipment.

.47 Considering the increase in leasing activities, auditors should refresh their understanding of the relevant accounting guidance regarding leasing and determine that lease arrangements at their construction clients are properly accounted for.

.48 FASB Statement No. 13, *Accounting for Leases* (FASB, *Current Text*, vol. 1, sec. L10), is the primary guidance concerning lease accounting. Many amendments to and interpretations of FASB Statement No. 13 have been issued, and numerous FASB Emerging Issues Task Force (EITF) consensus addresses accounting for leases. Auditors should become familiar with the relevant guidance related to lease accounting. In planning the engagement, auditors should identify material lease agreements and determine whether their clients are complying with their obligations under those agreements. To be able to determine whether the client has properly accounted for and disclosed its lease agreements, the auditor will need to understand the

lease agreements, how the leases should be classified, and what accounting treatment is appropriate under those classifications. In addition, auditors should keep in mind the following audit procedures when examining lease agreements:

- Consider the advisability of obtaining from the lessor confirmation of compliance with restrictive covenants and other pertinent details of significant lease agreements.
- Refer to the applicable accounting standards for a description of disclosure information, such as rental expenses, minimum future rental payments, and general description of leasing arrangements.
- Determine whether proper consideration was given to noncapitalizable costs (such as taxes, insurance, and maintenance) in computing the amount of lease cost capitalized.

.49 In addition to the authoritative guidance regarding accounting for leases, auditors can obtain from the AICPA a computer-based training course titled *Accounting for Leases* (Product No. 702377). This course will also provide the auditor with eight hours of continuing professional education credit.

### Analytical Review Concern<sup>1</sup>

*What should an auditor be careful about avoiding, when performing analytical procedures?*

.50 Authoritative guidance on the use of analytical procedures by auditors is set forth in SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329). The analytical review process includes various procedures used to evaluate the financial position and operations of a contractor. Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor.

.51 Recent research indicates that a concern exists in that some auditors are allowing unaudited account balances (or ratios) to unduly influence expectations of what current balances should be, when performing analytical procedures. Relying on current unaudited balances may bias an auditor when deciding whether to further investigate and may possibly adversely affect audit efficiency or effectiveness. Audit testing should involve the corroboration of account balances by comparing unaudited balances with independent expectations of what those balances should be. The audit test would be unreliable if the expectation of an account balance or ratio was unduly influenced by unaudited amounts. Auditors should keep these points in mind when performing analytical procedures.

### EITF Issue Nos. 97-10 and 97-11

*How do EITF Issue Nos. 97-10 and 97-11 apply to construction contractors?*

.52 EITF Issue 97-10, *The Effect of Lessee Involvement in Asset Construction*, addresses how an entity (lessee) that is involved with the construction of an asset that it will lease when construction is completed should determine whether it should be considered the owner of that asset during the construction period. EITF Issue No. 97-10 would apply if an entity constructing a building will also lease more than a minor portion of the building. If this issue is relevant, auditors should consider the requirements of EITF Issue No. 97-10, and the client's compliance with those requirements.

.53 EITF Issue No. 97-11, *Accounting for Internal Costs Relating to Real Estate Property Acquisitions*, states that the internal costs of preacquisition activities incurred in connection with the acquisition of an operating property should be expensed as incurred. Auditors should be familiar with the requirements of EITF Issue No. 97-11 if their construction client has acquired property prior to construction. In a related manner, the FASB is working on a proposed Statement that would amend FASB Statement No. 66, *Accounting for Sales of Real Estate* (FASB, *Current Text*, vol. 1, sec. R10), to clarify that the scope of that Statement is consistent with

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<sup>1</sup> This section is adapted from the November 1997 *Journal of Accountancy*.

the scope of FASB Statement No. 98, *Accounting for Leases* (FASB, *Current Text*, vol. 1, sec. L10). FASB Statement No. 66 does not explicitly define real estate or explain to what real estate transactions it is specifically applicable. The proposed Statement would state that the provisions of FASB Statement No. 66 apply to all sales of real estate with property improvements or integral equipment such as manufacturing facilities, power plants, and refineries. Auditors should be alert to a final pronouncement by the FASB on this matter.

#### Executive Summary—Audit Issues and Developments

- With revenue recognition problems receiving so much attention lately, auditors may want to strengthen their focus on revenue recognition at their clients. Auditors should determine that the requirements of SOP 81-1 are being met. SAS No. 57 provides guidance on auditing estimates.
- Auditors should be alert to the use by management of overly optimistic assumptions during prosperous times. Job site visits can assist the auditor in assessing the reasonableness of management assumptions.
- If economic conditions deteriorate, auditors should be alert to contractors entering into high-risk contracts in the hope of maintaining results achieved during better times.
- The inability of most computer programs to distinguish the year 1900 AD from the year 2000 AD poses substantial risks to construction contractors. The AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] addresses the auditing and accounting issues related to the year 2000 issue.
- The misappropriation of heavy construction equipment is a growing problem in the industry. An auditor would be concerned if there is a risk that the theft of heavy equipment causes the construction contractor's financial statements to be materially misstated.
- Auditors should assess the potential effect that the global economic crisis may have on their construction clients.
- Auditors may want to determine whether the labor shortage problem in the industry has a significant effect on their clients. Issues such as breach of contract, liabilities related to faulty work, and contract disputes may arise because of the labor shortages.
- Auditors should be aware of the extent of leasing activities at their clients and should determine that generally accepted accounting principles (GAAP) are being properly applied.
- When auditors are performing analytical procedures, they should remember not to let unaudited account balances or ratios unduly influence expectations of what current balances should be.
- Auditors should be aware of the guidance contained in EITF Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*, and EITF Issue No. 97-11, *Accounting for Internal Costs Relating to Real Estate Property Acquisitions*, if such issues are relevant.

## New Auditing and Attestation Pronouncements

### *What new auditing and attestation standards have been issued?*

.54 Presented below are descriptions of recently issued auditing and attestation pronouncements that may be applicable to construction contractors. For a complete list and description of all new auditing and attestation developments, including Audit Issues Task Force (AITF) Interpretations and AITF Advisories, auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010]. Call the AICPA Order Department at 1-(888)-777-7077 to order.

### New Auditing Standards

#### **SAS No. 86, Amendment to Statement on Auditing Standards No. 72, *Letters for Underwriters and Certain Other Requesting Parties***

.55 The Auditing Standards Board (ASB) issued SAS No. 86 in March 1998 to reflect the issuance of SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86

allows practitioners that have examined or reviewed management's discussion and analysis (MD&A), in accordance with the provisions of SSAE No. 8, to state that fact in the introductory section of the comfort letter (a special kind of agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

### **SAS No. 87, Restricting the Use of an Auditor's Report**

.56 The ASB issued SAS No. 87 in September 1998 and it is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The Statement states that an auditor should restrict the use of a report when—

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

.57 In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used in restricted-use reports, and requires an auditor to restrict a single combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

### **SAS No. 21 Rescinded**

.58 SAS No. 21, *Segment Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 435), contained guidance for auditing disclosures made in accordance with the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 was superseded upon the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30), which is effective for fiscal years beginning after December 15, 1997. Accordingly, the ASB has rescinded SAS No. 21 effective for audits of financial statements to which FASB Statement No. 131 has been applied. In its place, Auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31 has been issued. See the "New Auditing Interpretations and AITF Advisory" section of the general *Audit Risk Alert—1998/99* [AAM section 8010] for a more detailed discussion of the new Interpretation.

## **New Attestation Standard**

### **SSAE No. 8, Management's Discussion and Analysis**

.59 Issued by the ASB in March 1998, SSAE No. 8 provides guidance to a practitioner concerning the performance of a review or examination of MD&A prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8—

1. Sets conditions for engagement performance for both examinations and reviews of MD&A.
2. Provides extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A.
3. Provides a comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8.

SSAE No. 8 became effective upon issuance.

.60 In September 1998, the ASB voted to issue the exposure draft *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity's Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation* as a final standard. See the "Exposure Draft Issued by the Auditing Standards Board" section of the general *Audit Risk Alert—1998/99* [AAM section 8010] for further information.

#### Executive Summary—New Auditing and Attestation Developments

- See the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a thorough listing of new auditing and attestation developments.
- SAS No. 86, Amendment to SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties*
- SAS No. 87, *Restricting the Use of an Auditor's Report*
- SAS No. 21, *Segment Information*—Rescinded
- SSAE No. 8, *Management's Discussion and Analysis*

## Accounting Issues and Developments

*What new accounting pronouncements have been issued?*

.61 Presented below are descriptions of some recent accounting developments that auditors should know about. Auditors should read the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] for a complete listing and description of recent GAAP developments, including FASB EITF Consensus Positions and AICPA SOPs. Call the AICPA Order Department at 1-(888)-777-7077 to order.

### New FASB Pronouncements

#### **FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106**

.62 In February 1998, the FASB issued Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (FASB, *Current Text*, vol. 1, secs. P16 and P40). FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statement Nos. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16); 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, sec. P16); and 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*

(FASB, *Current Text*, vol. 1, sec. P40), were issued. FASB Statement No. 132 suggests combined formats for the presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

.63 FASB Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

### ***FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities***

.64 In June 1998, the FASB issued Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities*. FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (b) a hedge of the exposure to variable cash flows of a forecasted transaction; or (c) a hedge of the foreign-currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.65 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.66 For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a fair-value hedge), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

.67 For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a cash-flow hedge), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

.68 For a derivative designated as hedging the foreign-currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair-value hedge described above applies to a derivative designated as a hedge of the foreign-currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign-currency exposure of a foreign-currency-denominated forecasted transaction.

.69 For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.70 Under FASB Statement No. 133, an entity that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

.71 FASB Statement No. 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction, except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign-currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

.72 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign-currency-forecasted transaction with a derivative. It supersedes FASB Statement Nos. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80); 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25); and 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107 to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. FASB Statement No. 133 also nullifies or modifies the consensuses reached in a number of issues addressed by the EITF.

.73 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter. On that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

**FASB Statement No. 134, Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65**

.74 In October 1998, the FASB issued Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65*. FASB Statement No. 65, as amended by FASB Statement Nos. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that, after the securitization of a mortgage loan held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed security as a trading security. This Statement further amends FASB Statement No. 65 to require that after the securitization of mortgage loans held for sale, an entity engaged in mortgage banking activities classify the resulting mortgage-backed securities or other retained interests based on its ability and intent to sell or hold those investments. This Statement conforms the subsequent accounting for securities retained after the securitization of mortgage loans by a mortgage banking enterprise with the subsequent accounting for securities retained after the securitization of other kinds of assets by a nonmortgage banking enterprise.

.75 This Statement shall be effective for the first fiscal quarter beginning after December 15, 1998. Early application is encouraged and is permitted as of the issuance of this Statement. On the date this Statement is initially applied, an enterprise may reclassify mortgage-backed securities and other beneficial interests retained after the securitization of mortgage loans held for sale from the trading category, except for those with sales commitments in place.<sup>2</sup> Those securities and other interests shall be classified based on the entity's ability and intent, on the date this Statement is initially applied, to hold those investments. Transfers from the trading category that result from implementing this Statement shall be accounted for in accordance with paragraph 15(a) of FASB Statement No. 115.

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<sup>2</sup> Mortgage-backed securities and other beneficial interests may be reclassified from the trading category when initially applying this Statement without regard for the provisions in paragraph 15 of FASB Statement No. 115, which states that "given the nature of a trading security, transfers into or from the trading category . . . should be rare."

### Executive Summary—New Accounting Developments

- See the AICPA general *Audit Risk Alert*—1998/99 [AAM section 8010] for a thorough listing of new accounting developments.
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statement Nos. 87, 88, and 106*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65*

## AICPA Audit and Accounting Literature

### Audit and Accounting Guide

.76 The AICPA Audit and Accounting Guide *Construction Contractors* is available through the AICPA looseleaf subscription service. In the looseleaf 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 Guide as it appears in the service are printed annually.

### Construction Contractors' Financial Reporting Checklist

.77 The AICPA has published a publication titled *Checklists Supplement and Illustrative Financial Statements for Construction Contractors* as a tool for preparers and reviewers of financial statements of construction contractors.

## References for Additional Guidance

*What are some organizations that can provide more information about the construction industry?*

.78 Further information on matters addressed in this Audit Risk Alert is available through various publications and services listed in the following table entitled "Information Sources." Many nongovernment and some government publications and services involve a charge or membership requirement.

.79 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.

.80 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

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.81 This Audit Risk Alert replaces *Construction Contractors Industry Developments*—1997/98.

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.82 Practitioners should also be aware of the economic, regulatory, and professional developments described in the AICPA general *Audit Risk Alert—1998/99* [AAM section 8010] and *Compilation and Review Alert—1998/99* [AAM section 8015], which may be obtained by calling the AICPA Order Department at 1-(888)-777-7077.

.83 The *Construction Contractors Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be appreciated. You may email these comments to [Rdurak@aicpa.org](mailto:Rdurak@aicpa.org), or write to:

Robert Durak, CPA  
AICPA  
Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

## Information Sources

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Organization	General Information	Fax/Phone Services	Internet Web Site	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	<a href="http://www.aicpa.org">http://www.aicpa.org</a>	
Financial Accounting Standards Board	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		<a href="http://www.fasb.org">http://www.fasb.org</a>	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)	<a href="http://www.sec.gov">http://www.sec.gov</a>	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	<a href="http://www.doc.gov">http://www.doc.gov</a>	
Associated General Contractors of America	1957 E Street, NW Washington, DC 20006	General Information (202) 393-2040	<a href="http://www.agc.org">http://www.agc.org</a>	
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		

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# AAM Section 8100

## *Investment Companies Industry Developments—1998/99*

### In This Year's Alert . . .

- What significant industry and economic developments are relevant to the audits of investment companies?
- What are some of the final rules issued by the SEC since the last Audit Risk Alert?
- What are the significant issues raised in the most recent "Dear CFO" Letter?
- What are some of the audit issues associated with an investment company's valuation of its securities portfolio?
- What is the Year 2000 Issue? What industry and regulatory developments have taken place in the last year with respect to the Year 2000 Issue?
- How will the European Union's adoption of a new reporting currency affect investment companies?
- What is money laundering? What are the auditor's responsibilities with respect to money laundering?
- What new audit and attestation standards has the AICPA issued since the last Audit Risk Alert?
- What are the highlights of the proposed AICPA Audit and Accounting Guide *Audits of Investment Companies*?
- Which FASB Statement No. 125 application issues should auditors of investment companies be aware of?
- How does implementation of FASB Statement No. 133 affect investment companies?
- How does implementation of SOP 98-5 affect investment companies?

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### Industry and Economic Developments

*What significant industry and economic developments  
are relevant to the audits of investment companies?*

.01 The year 1998 was one of give-and-take in the investment company industry. At midyear, after months of attracting record-breaking fund inflows, and gaining 13 percent in total industry assets from the end of 1997—the result of continued strength in the domestic economy—the industry was forced to give back some of its gains. Following repeated warnings that U.S. corporate earnings would soften due to deepening recessions in Asian economies, the global and domestic outlook turned decidedly bleak in the third quarter, and the Dow Jones Industrial Average (DJIA) began its decent. Over a six-week period, the DJIA plunged nearly 1800 points or 19 percent from its record high of 9338, the result of severe investor anxiety over a worsening global economic crisis affecting Asia, Russia, and Latin America, and political concerns at home and abroad.

.02 During the third quarter of 1998, a number of equity and bond markets, particularly in emerging economies, suffered significant declines due to political and economic factors. Currencies of several nations declined as well. Of particular concern to investors was the devaluation of the Russian ruble and Russia's de facto default on hundreds of millions of dollars in debt. In Malaysia, the local government fixed the exchange rate of its currency, the ringgit, and imposed controls over the flow of capital outside of the country. Toward the end of the third quarter, the Federal Reserve Bank organized a private bailout by a group of elite banks and brokerage firms of Long-Term Capital Management, L.P., a huge hedge fund with an estimated exposure of \$1.25 trillion to international markets, on fears that the fund's imminent collapse would damage world markets further.

.03 The table below illustrates some of the significant securities market declines that took place in 1998.

<i>Percentage Decline in Foreign Market Indexes between 12/31/97 and 9/10/98</i>	
Hong Kong	26.8%
Singapore	43.5%
Mexico City	45.4%

In light of these declines, auditors should consider the possibility that economic conditions existing in the jurisdictions in which funds invest might have increased the level of inherent risk of the audit, even introducing going concern considerations among funds that had concentrated investments in these jurisdictions or used significant leverage to obtain those investments. Further, the investment company may have adopted special procedures, or engaged in nonrecurring transactions, to address operational or investment risks that have arisen during 1998, which may increase the inherent or control risk of the audit. The auditor should gain an appropriate understanding of all such procedures and transactions to determine their effect on the investment company's financial reporting and disclosures.

.04 In addition, economic declines in a number of emerging markets have impaired the capacity of many issuers of fixed-income securities, both corporations and governments, to service their debt, causing actual or potential defaults in the payment of interest and principal. AICPA Statement of Position (SOP) 93-1, *Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies*, provides guidance on the accounting for accrued income and purchased interest in connection with defaulted debt securities, and should be consulted as such situations arise.

.05 Global events notwithstanding, rapid growth in the industry over recent years (growth rates exceeding 25 percent<sup>1</sup> were achieved for each of the three years ending December 31, 1997) has spurred unprecedented growth in available products as well as many new entrants. Nearly every imaginable investment objective has been created—in fact, there are more funds in existence today than individual stocks listed on the New York Stock Exchange. This explosive growth has created a fiercely competitive environment, in which investment companies have been under pressure to improve (or at least maintain) investment performance, broaden product lines, cut expenses, and secure new distribution channels (including the Internet) domestically and internationally. Auditors need to be particularly aware that this competitive environment, coupled with recent market conditions, may cause additional strain on an investment company's operations and existing internal control, which could manifest itself in activities such as—

- Yield stretching (a portfolio manager's investment in higher yield (and therefore, higher risk) financial instruments than the manager normally would consider).
- Deploying higher risk and permissible, but seldom-used, investment techniques.

<sup>1</sup> Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires that auditors use analytical procedures during the planning and review stages of all audits. Statistical information such as the type shown may be useful to auditors in applying the provisions of SAS No. 56. A listing of auditor Web sites appears in appendix A.

- Pressures exerted on the timeliness and accuracy of fair value procedures (such as concern about whether the board of directors is sufficiently involved).
- Illiquidity concerns.

If the auditor concludes that additional strain has been exerted upon the entity's operations and internal control, he or she may find it necessary to assess control risk at higher levels for some or all of the financial statement assertions, and to adjust the audit scope accordingly. Further, the auditor may conclude that weaknesses in internal control constitute significant deficiencies in the design or operation of internal control that could adversely affect the investment company's ability to record, process, and report financial data, in which case reportable conditions exist. In such circumstances, auditors should refer to Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which provides guidance in identifying and reporting conditions that relate to an entity's internal control observed during the annual financial statement audit. In addition, the Securities and Exchange Commission's (SEC) Form N-SAR requires auditors of registered investment companies to report on an investment company's internal control (based on the procedures performed during the annual financial statement audit), including control procedures for safeguarding securities (see paragraph 8.24 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*).

.06 Significant fluctuations and uncertainties in the global economy and capital markets underscore the need for auditors to carefully evaluate the reasonableness of a fund management's securities valuations. Before evaluating the reasonableness of these valuations, the auditor should gain a sufficient understanding of board-approved procedures and their applications, particularly when the fund invests in rapidly changing or uncertain markets (such as Russia or Southeast Asia), industries (such as technology), or classes of investments (such as certain types of mortgage-backed securities). In these circumstances, the auditor may need to spend additional time to fully understand fair value procedures and applications associated with these types of investments.

.07 Some of the factors that auditors may wish to consider in assessing valuations for reasonableness are—

- Lack (or cessation) of trading activity in certain markets to the point where market quotations are unreliable.
- Timing differences between the close of foreign markets and fund pricing where significant events have transpired after the foreign market's close.
- Imposition of trading halts during periods of excessive volatility.
- Worldwide stock market volatility and instability.
- Competitive pressures leading investment companies to adopt new trading strategies.

See the "Audit Issues and Developments" section of this Alert for a further discussion of valuation issues.

.08 The unexpected and far-reaching turn of events affecting several global economies and capital markets has significantly affected the investment company industry, surprising even long-time observers. In August, the industry experienced its first net outflows from equity funds in more than seven years (most of which was money shifted into more conservative bond and money market funds). Emerging market and junk bond funds, victims of global economic turbulence and investors' flight to the safety of U.S. treasury securities, suffered devastating declines in value and significant redemptions, causing some liquidations. And with recent events exacerbating the highly competitive environment of the investment company industry, analysts expect competitive pressures to continue to mount, pressing firms to improve or maintain investment performance, to better rationalize their cost structure and committed capital, and to more actively consider alliances and consolidation options. At this juncture, industry experts are divided as to whether the full extent of the damage caused by the global events of 1998 has been realized and what the prospects for fund flows will be through the remainder of 1998.

**Executive Summary—Industry and Economic Developments**

- The investment company industry, which attracted healthy inflows in the first half of 1998, experienced outflows after midyear, especially from emerging market, international, and junk bond funds.
- Economic declines in a number of emerging markets hit home by mid-1998, driving U.S. stock prices significantly lower and causing major domestic economic uncertainties. Such declines and the adoption of special procedures by firms to address operational or investment risks may increase the inherent risk of the audit.
- Due to extreme volatility in capital markets worldwide and the slowdown of activity in some markets, timing differences, and imposition of trading halts in certain foreign markets, auditors may wish to reassess the relevance of a fund management's valuations of its securities portfolios.
- Auditors may wish to consider the effects of rapid growth, competitive pressures, and cost cutting on an investment company's internal control.

## Regulatory and Legislative Developments

### SEC Regulations

*What are some of the final rules issued by the SEC since the last Audit Risk Alert?*

.09 Many investment companies are required to register under the Investment Company Act of 1940 (the 1940 Act), the Securities Act of 1933 (the 1933 Act), the Securities Exchange Act of 1934 (the 1934 Act), and with various state security commissions. Auditors of investment companies should be familiar with the provisions of these regulations before undertaking audits of these heavily regulated entities.

.10 The SEC issued the following final rules since the last Audit Risk Alert:

**Simplified Calculation of Registration Fees.** The SEC amended the rule and the form under the 1940 Act that prescribes the method by which certain investment companies calculate and pay registration fees under the 1933 Act. The amendments implement the provisions of the National Securities Markets Improvement Act of 1996, which simplifies the method of determining the amount of those fees. Effective date: October 11, 1997.

**Amendments Relating to Multiple Class and Series Investment Companies.** The SEC adopted amendments to rule 18f-3 of the 1940 Act, which permits open-ended management investment companies (mutual funds) to issue multiple classes of shares representing interests in the same portfolio. The amendments extend and clarify the methods by which a multiple class fund may allocate among its classes income, gains and losses, and expenses not allocated to a particular class. The amendments also clarify the shareholder voting provisions of the rule. Effective date: November 10, 1997.

**New Disclosure Option for Open-Ended Management Investment Companies (Mutual Funds).** The SEC adopted a new rule that permits a mutual fund that registers on Form N-1A to offer investors a new disclosure document called a "profile," which summarizes key information about the mutual fund, including the fund's investment strategies, risks, performance, and fees, in a concise, standardized format. The new disclosure option gives a fund's prospective investors a choice about the amount of information they wish to consider before making an investment decision. Effective date: June 1, 1998.

**Form N1-A Amendments.** The SEC adopted amendments to Form N-1A, the form used by mutual funds to register under the 1940 Act and to offer their shares under the Securities Act of 1933. A key component of the new form is the "Risk/Return Summary," to be included at the beginning of every prospectus. Basic components of the Risk/Return Summary include—

- Investment strategies and objectives, and how the fund will attempt to achieve those objectives.
- Risk/return information, which includes a discussion of the principal risks of investing in the fund. This discussion should inform the prospective investor of the risk associated with the fund's portfolio holdings as a whole, and the circumstances that might adversely affect the fund's total return, net asset value, or yield. Funds may choose to describe the type of investor for which the fund was intended, the types of investment goals that may be achieved by investing in the fund, or both.
- A bar chart that indicates the fund's annual returns for each of the last ten calendar years.
- A performance table comparing the fund's average annual returns over the last one, five, and ten calendar-year periods to a broad-based securities market index (such as the *Standard & Poor's 500*), including a brief explanatory narrative and disclosure of the fund's best and worse returns for a quarter covered by the bar chart.
- A fee table, including annual fund operating expenses before expense reimbursement or fee waiver arrangements.

Annual returns presented within the bar chart information should be calculated using the same method required in calculating annual returns in the financial highlights information.

The form, as amended, no longer requires the filing of updated financial statements for newly organized funds. (Previously, such funds were required to file updated financial statements within four to six months of the effective date of their registration statements.) The period covered by the financial highlights table has been reduced from ten to five years.

The initial compliance date is December 1, 1998, for all new registration statement filings. Funds with effective registration statements must conform to Form N1-A amendments between December 1, 1998, and December 1, 1999. Effective date: June 1, 1998.

**Technical Amendments to Rule 2a-7.** Rule 2a-7 of the 1940 Act contains regulations specific to money market funds including quality, diversification, and maturity restrictions. In December 1997, the SEC adopted technical amendments to rule 2a-7, which follow previous amendments adopted in 1996 that extended to tax-exempt funds some of the restrictions applicable to taxable funds. Due to a number of concerns raised, the SEC suspended the compliance date for the 1996 amendments. The December 1997 amendments addressed those concerns and also extended certain diversification and quality standards to all money market funds. Overall, the amendments will substantially increase recordkeeping requirements. Effective date: July 1, 1998 (except with respect to certain grandfathered securities).

The complete text of the above rules, along with those rules adopted subsequent to the publication of this Alert, can be downloaded from the SEC's Web site at <http://www.sec.gov/rules/finnrindx.htm>.

## SEC Policy Statement on Auditor Independence

.11 In 1997, the AICPA and the SEC created a new self-regulatory body to develop and maintain independence standards for auditors of SEC registrants. The Independence Standards Board (ISB) is housed in the AICPA's SEC Practice Section (SECPS) and consists of four public members and four representatives of SECPS. By way of a policy statement effective March 26, 1998, the SEC recognized the establishment of the ISB. The SEC indicated that, consistent with its continuing policy of looking to the private sector for leadership in establishing and improving accounting principles and auditing standards, it intends to look to the ISB for leadership in establishing and improving auditor independence regulations applicable to auditors of SEC registrants.

## Recent Developments in Securities Litigation Reform

.12 The 1995 Private Securities Litigation Reform Act (Reform Act) promised significant relief to the accounting profession from unmerited class action securities lawsuits involving publicly held entities. De-

spite a historic bull market, studies have shown little, if any, decrease in the volume of federal securities litigation filed. Furthermore, some litigants appeared to have avoided the provisions of the Reform Act by filing suit in state courts instead of, or in addition to, suing in federal court. These observations prompted Congress to consider an amendment to the Reform Act, which would denote federal court as the sole venue for class action suits involving securities traded on national exchanges, preempting the filing of these suits in state court. In 1998, the House and Senate approved the Securities Litigation Uniform Standards Act, which will allow class action securities lawsuits involving nationally traded securities and more than fifty parties to be moved to federal court. The legislation has the support of both the White House and the SEC.

.13 For further information regarding the legislation, contact the following Web sites:

- <http://www.sia.com>
- <http://www.securitieslitigation.com>
- <http://www.ljx.com/practice/securities/1204pslra.html>

## SEC Annual “Dear CFO” Letter

*What are the significant issues raised in the most recent “Dear CFO” Letter?*

.14 The accounting staff of the Division of Investment Management of the SEC periodically issues a generic letter addressed to the chief financial officers (CFOs) of investment company registrants (registrants) and their independent public accountants outlining key issues addressed by the SEC during the year. These letters point out the SEC’s areas of concern and accordingly may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of investment companies. The following summary highlights the areas of concern cited in the November 1997 letter:

- *Foreign Price Considerations.* The 1996 CFO Letter indicated that funds must exercise “reasonable diligence” in identifying foreign corporate actions, such as dividend distributions, on a timely basis for purposes of daily determinations of net asset value. Subsequently, registrants inquired as to whether a reasonable diligence standard extends to the pricing of foreign securities. The 1997 letter indicates that the SEC’s Accounting Series Release Nos. 113 and 118 of the SEC’s *Codification of Financial Reporting Policies* (FRP) are the applicable standards for accounting and valuation of investments, and that the reasonable diligence standard should not be extended to the pricing of securities.
- *Funds of Funds.* The letter addresses the financial reporting considerations where one fund, the “top-tier fund,” invests in shares of another fund, the “underlying fund.” The letter notes that when a top-tier fund has a significant investment in, or owns a controlling interest in, an underlying fund, registrants should consider providing additional information to shareholders. For example, a top-tier fund that invests a significant percentage of its assets in an underlying fund should consider accompanying its financial statements with those of the underlying fund. Additionally, a top-tier fund that owns a controlling interest in an underlying fund should consider current accounting literature to determine whether consolidation of the two funds’ financial statements would provide more meaningful financial information to shareholders.
- *Designation of Segregated Assets.* Certain trading practices undertaken by registrants involve the issuance of senior securities subject to prohibitions and asset coverage requirements of section 18 of the 1940 Act. In 1979, the SEC issued a policy statement indicating that certain instruments held by a fund would not be subject to those requirements if the fund’s obligation was “covered” by assets established and maintained by the fund in a segregated account. Typically, investment companies designate securities to be segregated on their custodians’ records. Registrants inquired whether accounts should be segregated on both the fund’s records and the custodian’s records. The letter indicated assets segregated under section 18 could be designated as such solely on the fund’s records



and not designated in the records of the fund's custodian. (Investment companies choosing the latter should consider implementing additional control procedures to ensure that segregation is undertaken in accordance with Investment Company Act of 1940 Release No. 10666.)

- *Securities Lending Transactions and FASB Statement No. 125.* The letter indicates that, consistent with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Current Text*, vol. 1, sec. L35), a fund lending its portfolio securities should not record securities received as collateral from the borrower as an asset unless the fund has "effective control" over the securities received. In cases where a fund has effective control over the collateral, the fund should record an asset and a corresponding liability. The division noted some inconsistencies in the accounting for cash received as collateral. The letter indicates that when a lending fund receives cash as collateral, it is deemed to have effective control and should record an asset and a corresponding liability, even if the cash is automatically invested in securities. (Application issues associated with FASB Statement No. 125 are also discussed in the "Accounting Issues and Developments" section of this Alert.)
- *Closed-End Fund Expense Ratios.* The letter noted inconsistencies in the calculation of expense ratios for funds that have incurred interest expense on debt securities or paid dividends on preferred shares. Form N-2, Financial Highlights, requires expense ratios to include all expenses of a fund. Registrants asked whether an additional expense ratio might be presented as part of the financial highlights table, that is, one that excludes interest expense. The letter indicates that closed-end funds may include a second expense ratio, excluding interest payments, in the body of the financial highlights table or as a footnote to the table. The letter emphasized that, in all cases, the expense ratio that includes interest expense (gross ratio) should be shown in the body of the financial highlights and that both ratios should be clearly identified with appropriate disclosure as to the differences. The letter also indicates that closed-end funds with preferred shares outstanding should exclude dividend payments from the expense ratio included in the body of the financial highlights table. Further, the letter indicates that the expense ratio of such funds should be based on assets attributable to the common shares only. Additional ratios could be presented reflecting the treatment of preferred shares within the footnotes to the financial highlights table. Changes conforming expense ratio presentation to these positions should be reflected in financial statements for fiscal years beginning after November 15, 1997.
- *Organizational Costs.* The letter states that the remaining organization costs recognized by a fund that is being merged, liquidated, or dissolved are the responsibility of the holder of the original shares, and should be netted against the redemption proceeds of the original shares. The letter indicated that it is inappropriate to accelerate write-off of the remaining organization costs to the date of the proposed transaction. The effect of this position was subsequently mitigated by adoption of SOP 98-5, *Reporting the Costs of Start-Up Activities* (discussed in the "Accounting Issues and Developments" section of this Alert).

A 1998 letter is expected to be available by early November.

## Audit Issues and Developments

### Securities Valuation Considerations

*What are some of the audit issues associated with an investment company's valuation of its securities portfolio?*

.15 The most significant portion of an investment company's assets is its securities portfolio, which is stated at value. The Investment Company Act of 1940 defines "value" as the quoted market price for securities for which market quotations are readily available, or as an estimate of value (fair value) as determined in good faith by a fund's management for other securities.<sup>2</sup> For assets and shareholders' equity to be reported

<sup>2</sup> Section 404.03-.04 of the Securities and Exchange Commission's (SEC) *Codification of Financial Reporting Policies* (FRP) describes various methods for valuing securities.

properly, and for purchase and redemption prices to be calculated accurately, the underlying securities of a fund's portfolio must reflect value. For these reasons, management's determination of what constitutes value is a primary concern for auditors of investment companies.

.16 Events occurring in the equity and bond markets during 1998 have created numerous accounting and disclosure issues pertaining to the valuation of securities, many of which are addressed in AICPA and SEC literature. Specifically, the ability to obtain quoted security valuations has become more difficult in certain markets, and, when obtained, questions have arisen whether such valuations represent an amount an owner could reasonably expect to receive for the securities in a current sale. Issues that have arisen include—

- *Lack of trading activity.* Trading activity in certain markets has declined significantly, to the point that, in some cases, trading in some securities has effectively ceased. In these situations, the auditor should carefully evaluate any market quotations used by management in valuing securities to gain assurance that the quotations represent current trading activity and to assess whether the market has become so stagnant that even current prices no longer represent realizable value.
- *Timing differences between close of local market and fund pricing, and trading halts.* Most investment companies value their shares for purposes of fund sales and redemptions at 4 p.m. eastern (U.S.) standard time, while most foreign markets close at earlier times. Typically, funds use the most recent previous closing price of the foreign market to value their shares. On occasion, however, significant events may occur after the foreign market's close, but before the time the fund values its shares, which would affect the valuation of those securities. As a result of a period of significant market volatility in October 1997, the SEC staff reiterated its position<sup>3</sup> that funds should consider additional information, if any, affecting changes in security values after the close of foreign exchanges on which such securities are traded. Similarly, in some cases, securities markets may have imposed trading halts during periods of excessive volatility. Should such a halt have been imposed at the time the fund obtains price quotations for purposes of determining the net asset value of its shares, the quotations may not represent the current realizable value of the security. Either situation may require management to substitute estimates of fair value for the affected securities determined in good faith for the last exchange quotations.
- *Other factors.* In a market where exchange controls exist, even though market quotations for securities exist, the auditor should assess whether management's use of these quotations is representative of fair value. Issues to be considered in such an environment include:
  - How, when, and at what exchange rate the fund will be able to repatriate its investments.
  - The extent to which demand for local market securities has been temporarily exaggerated (and prices bid up) by numerous investors' inability to repatriate funds.
  - The potential effect on prices if controls were to be lifted.
  - Other regulatory restrictions that may have made it difficult for investors to liquidate security or currency holdings.

Accordingly, the auditor should evaluate procedures applied by the fund's management in considering whether, and to what extent, local market quotations may need to be adjusted in order to adequately represent the value the fund would reasonably expect to receive on disposition and repatriation. Any security and currency holdings in a market subject to controls must be assessed to determine whether they are illiquid, that is, proceeds are unavailable to fund redemptions.

.17 Auditors should consider SEC FRP section 404.03-.04, chapter 2 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*, and FASB Statement No. 107, *Disclosures about Fair Value of Financial*

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<sup>3</sup> See SEC No-Action Letter, *Putnam Growth Fund, Putnam International Equities Fund, Inc.*, of January 23, 1981.

*Instruments* (FASB, *Current Text*, vol. 1, sec. F25), when evaluating methods employed by management in estimating fair value. Auditors may also wish to consider SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, in evaluating management's disclosures about fair value.

.18 Although FASB Statement No. 107 states that quoted market prices, if available, are the best evidence of fair value of financial instruments, the economic and market conditions described above illustrate that, in certain situations, management's estimate of fair value as determined in good faith provides a more appropriate valuation. In such situations, the auditor should review management's documentation supporting its reasons for substituting estimates of fair value for quoted market prices. Auditors should also assess the reasonableness of the procedures used and factors considered by management in making such estimates. Auditors should refer to the guidance of SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), in doing so.

.19 In applying SAS No. 57, auditors may wish to consider these additional factors:

- *Stock Market Volatility.* Auditors may wish to consider the impact of sudden and significant stock market fluctuations on the relevance of key factors and assumptions used by management in estimating the value of an investment company's security portfolio. Worldwide stock market volatility and instability has been the most widespread and severe seen in several years. Domestically, during the third quarter, the DJIA gained or lost at least 100 points in ten of twelve consecutive trading sessions, and intra-session swings have surprised even the experts. Some foreign exchanges have experienced far greater volatility. In the event that the fund's management employs matrix pricing or similar models, the auditor should evaluate the relevance of the models' existing assumptions for consistency with economic and industry developments.
- *Management's Adoption of New Trading Strategies.* Growth and competitive forces have caused some investment companies to adopt new trading strategies that include the use of more speculative, complex, and innovative investments. The adoption of new trading strategies often brings about new valuation procedures that cause factors different from those previously considered by the auditor to become significant to the estimate. Under these circumstances, the auditor should obtain additional written representation from management regarding key factors and assumptions used in determining estimates (AU sec. 342.09). The auditor may also wish to consider using the work of a specialist (see SAS No. 73, *Using the Work of a Specialist*, AICPA *Professional Standards*, vol. 1, AU sec. 336).

#### Executive Summary—Securities Valuation Considerations

- Significant declines in securities and currency valuations throughout the world, particularly those of several emerging markets, have caused various issues for auditors of investment companies, including valuation issues resulting from the diminishing reliability of quoted market prices.
- Valuation issues created by the lack of trading activity in certain markets, the effect of significant events occurring after the close of foreign markets, trading halts, and other factors require auditors to carefully consider management's good faith securities valuations. The AICPA and SEC literature contains guidance for assessing management's estimation of fair value.
- In evaluating management's good faith securities valuations, auditors should consider SAS No. 81, *Auditing Investments*, and SAS No. 57, *Auditing Accounting Estimates*. Auditors may also wish to consider whether certain economic factors and industry trends, such as increased stock market volatility and management's adoption of new trading strategies, have affected the key factors and assumptions management uses in valuing securities in good faith.

## The Year 2000 Issue

*What is the Year 2000 Issue? What industry and regulatory developments have taken place in the last year with respect to the Year 2000 Issue?*

.20 Some twenty years ago the cost of computer memory space was exorbitant—\$600,000 per megabyte compared to about ten cents today. For this reason, many computer programs were designed using a two-digit format to represent year data; for example, 1998 is coded as “98.” Without proper modification, many of these systems may fail to process year-related data accurately beyond the year 1999, a chilling thought in today’s global computer information age. Hence, the Year 2000 (or “Y2K”) Issue has become one of the most often discussed business topics of the past few years.

.21 The AICPA has been active in creating awareness of the Year 2000 Issue among its members and the public and providing guidance to auditors regarding their responsibilities in audits leading up to the year 2000. The SEC and several industry trade groups, such as the Investment Company Institute (ICI) and the Securities Industry Association (SIA), have taken proactive roles in guiding investment and other companies along in their preparations for the year 2000. Some of the efforts of these organizations are as follows:

- The AICPA has published articles, books, and other materials on the Year 2000 Issue. A comprehensive discussion of the numerous auditing and accounting issues related to the Year 2000 Issue is presented in the AICPA publication, *The Year 2000 Issue: Current Accounting and Auditing Guidance*. This publication is being updated for recent developments and is available free of charge at the AICPA’s Web site at <http://www.aicpa.org>. The AICPA also has created the Year 2000 Resource Page on its Web site. This page contains useful links to various year 2000 sites and publications.
- The Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB) issued three new audit interpretations specifically related to the Year 2000 Issue.
- The SEC spearheaded several initiatives to promote year 2000 readiness and has adopted a new rule under the Investment Advisers Act requiring investment advisers to file year 2000 “readiness” reports with the Commission. The SEC also issued final rules regarding year 2000 readiness reports to be made by investment companies meeting specific thresholds and certain nonbank transfer agents. In August, the SEC further issued *Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers* (the Interpretation). The Interpretation—
  - Requires investment advisers and investment companies that conclude that the Year 2000 Issue is material to their operating results and/or financial condition to provide disclosure in accordance with statutory provisions.
  - Requires investment advisers that are public companies to follow the Interpretation’s guidance for public companies.
  - Is not specifically applicable to investment companies. However, the SEC encourages investment companies to review the guidance for possible inclusion in periodic reports to shareholders or in special reports to shareholders on year 2000 matters, especially when the materiality of the Year 2000 Issue does not trigger a disclosure obligation in the investment company’s registration statement.
  - Cautions investment companies and investment advisers making year 2000 disclosure to avoid boilerplate disclosure that may not be meaningful to shareholders.

The interpretation may be viewed on the SEC’s Web site at <http://www.sec.gov/rules/concept/33-7558>.

.22 Additionally—

- The SIA’s Year 2000 Committee conducted preliminary tests during which it practiced executing and settling trades of stocks, options, mutual funds, unit investment trusts, and mortgage-backed securities. The success rate was estimated to be about 90 percent.

- The ICI has educated its members about the Year 2000 Issue via the Internet and other published materials.

Auditors should be aware of the many auditing and accounting considerations that arise out of the Year 2000 Issue, including audit planning, going concern issues, establishing an understanding with the client, revenue and expense recognition, and disclosure. A more comprehensive discussion of these considerations can be found in *Audit Risk Alert—1998/99* [AAM section 8010].

.23 Additional information relating to the Year 2000 Issue is available on the Internet at the following Web sites:

- The National Bulletin Board for the Year 2000—<http://www.year2000.com>
- Management Support Technology—<http://www.mstnet.com/year2000>

#### Executive Summary—The Year 2000 Issue

- The Year 2000 Issue is an important one for all companies, requiring major modifications of most companies' computer systems in order to prevent the failure of systems to recognize year-related data beyond 1999.
- The SEC, AICPA, and industry trade groups, such as the Investment Company Institute and the Securities Industry Association, have taken various measures to guide investment and other companies in their preparations for the year 2000.
- The SEC issued an interpretation that encourages investment companies to provide meaningful data to shareholders regarding year 2000-related information, especially when the materiality of the problem does not trigger a disclosure obligation in the investment company's registration statement.
- The SEC also adopted a new rule under the Investment Advisors Act requiring investment advisors to file year 2000 "readiness" reports and issued final rules regarding year 2000 readiness reports to be made by transfer agents and certain brokers and dealers.
- Auditors should be aware of the many auditing and accounting considerations that arise out of the Year 2000 Issue, including audit planning, going concern issues, establishing an understanding with the client, revenue and expense recognition, and disclosure.

### Europe's New Reporting Currency, The Euro

*How will the European Union's adoption of a new reporting currency affect investment companies?*

.24 On January 1, 1999, the European Union's Economic and Monetary Union (EMU) goes into effect and exchange rates between "legacy currencies"—currencies of the eleven European nations that currently constitute the EMU—and the Euro will be permanently set. On that date, all operations of the European Central Bank, as well as new issues of government debt, will be denominated in the Euro. A phase-in period will extend to January 1, 2002, for all monetary transactions (for example, payroll and bank accounts), with June 30, 2002, the last day on which to withdraw legacy currencies.

.25 The introduction of the Euro is a major economic event, yet some investment companies in the U.S. may have underestimated the amount of consideration and resources needed to properly deal with the conversion of currencies on the records of investment advisers due to their preoccupation with the Year 2000 Issue. Accordingly, auditors should consider the greater risks that may be associated with the conversion. Because of their heavy reliance on third party service providers, investment companies will be accounting for the simultaneous conversion of Euro currencies with investment advisors, custodians, and other vendors within a very brief period. Even good planning and execution will likely result in a large number of unreconciled items immediately following the initial conversion. Auditors should also carefully consider possible increased audit risks related to the valuation of securities, internal control, and foreign currency transactions related to the redenomination.

.26 The SEC issued Staff Legal Bulletin No. 6, which reminded investment companies to consider their disclosure obligations in connection with the conversion, including—

- Known trends and uncertainties that the investment company expects will have a material impact on revenues, expenses, or income from continuing operations.
- Competitive implications.
- Associated costs of the conversion (through July 1, 2002).
- Ability to make timely updates of required information.
- Currency exchange rate risk and derivatives exposure.
- Continuation of material contracts.
- Potential tax consequences.

.27 In Treasury Decision 8776, the Internal Revenue Service (IRS) issued a temporary regulation indicating that conversion of legacy currencies to the Euro will generally be considered a tax-neutral event for U.S. taxpayers. Accordingly, conversion of legacy currencies (held by the taxpayer) to the Euro and the conversion of legacy currency-denominated contracts, financial instruments, and other claims or obligations would not trigger recognition of gains or losses solely as a result of the conversion. However, otherwise applicable rules regarding the realization of gains or losses will continue to apply, for example, gains or losses incurred as a result of receipt of an unscheduled, fractional principal payment on a debt instrument due to a rounding convention or the modification of the indexes of a floating rate debt instrument. A final IRS regulation is expected before year end.

.28 The Emerging Issues Task Force (EITF) of the FASB has discussed Topic No. D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union (EMU)*. The following is a summary of the resulting SEC staff announcement:

- *Preparation of Comparative Financial Statements for Periods Prior to the Introduction of the Euro on January 1, 1999.* The staff stated that it would not object if an SEC registrant presents comparative financial statements in Euros for periods prior to January 1, 1999, by recasting previously reported financial statements into Euros using the exchange rate between the Euro and the prior reporting currency as of January 1, 1999 (a position that is consistent with that of the European Commission). Auditors should also consider SEC Regulation S-X, Rule 3-20(e), *Currency of Financial Statements of Foreign Private Issuers*, which requires a registrant to recast its financial statements as if the newly adopted currency had been used since at least the earliest period presented. The SEC staff interpreted this provision to require a methodology consistent with FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), that is, the income statement and statement of cash flows should be translated into the new reporting currency using weighted average exchange rates for the applicable periods, and assets and liabilities should be translated using exchange rates at the end of the applicable periods.

Financial statements reported in Euros by recasting based on the January 1, 1999, exchange rate would depict the same trends and relationships among a registrant's accounts as those previously reported prior to the introduction of the Euro. To decrease the likelihood that investors will inappropriately assume that the financial statements of various registrants that report in Euros are comparable, each page of the basic financial statements should indicate that prior year balances were restated into Euros using the January 1, 1999, exchange rate. In addition, the notes to the financial statements should disclose—

- The reporting currency that was previously used.
- The methodology used to restate prior year balances.
- The exchange rate as of January 1, 1999.

- A statement that the comparative financial statements reported in Euros depict the same trends as would have been presented had the company continued to present financial statements in the currency previously used.
- A statement that the financial statements for periods prior to January 1, 1999 will not be comparable to the financial statements of other companies that report in Euros and that restated amounts from a different currency than the one previously used by the company.

The EITF also discussed foreign currency translation adjustments related to the Euro's introduction. Auditors are advised to review the full text of the EITF Abstract related to Topic No. D-71 for further information.

#### **Executive Summary—Europe's New Reporting Currency, The Euro**

- On January 1, 1999, the European Union's Economic and Monetary Union (EMU) becomes effective and exchange rates between the currencies of eleven European nations (the EMU) and the Euro will be irrevocably fixed, a major economic event for investment companies and their investment advisers and custodians.
- SEC Staff Legal Bulletin No. 6 reminds investment companies to consider various disclosure obligations related to the conversion such as known trends and uncertainties that the investment company expects to have a material impact on revenues, expenses, or income from continuing operations and associated costs of the conversion.
- The IRS has issued a temporary regulation indicating that conversion of legacy currencies (those of the eleven nations constituting the EMU) to the Euro will generally be considered a tax-neutral event.
- In light of the redenomination, the EITF has discussed the preparation of comparative financial statements for periods prior to the introduction of the Euro and the treatment of foreign currency translation adjustments.

### **Money Laundering and the Auditor's Consideration of Illegal Acts<sup>4</sup>**

*What is money laundering?*

*What are the auditor's responsibilities with respect to money laundering?*

.29 Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from \$300 billion to \$1 trillion.<sup>5</sup>

.30 Criminals use bank and nonbank financial institutions and professional advisers to launder the proceeds of crime, and, according to the U.S. Department of Treasury, investment companies may also be vulnerable. The evolving dynamics of the industry—mergers and acquisitions, broader product lines, and new distribution channels—generate important business opportunities, but they also generate risks for investment companies, including increased money laundering vulnerability. As these industry trends continue, as money launderers increasingly look for a wide range of financial services and conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other nonbank financial institutions make it more difficult for them to evade detection, the securities industry may become increasingly vulnerable to money laundering and more attractive to money launderers.

.31 While money laundering activities and methods become increasingly complex and ingenious, its "operations" tend to consist of three basic stages or processes—placement, layering, and integration.

<sup>4</sup> The U.S. Department of Treasury has had significant input in drafting the content of this section of the Alert. As such, it provides auditors of investment companies with a unique insight into how federal regulators view this important area of concern.

<sup>5</sup> By definition, money launderers are in the business of cloaking their activities and revenue, making this approximation difficult.

**Placement** is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner as to avoid detection by bank and non-bank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends, and law enforcement strategies and techniques in order to keep their proceeds concealed, their methods secret, and their professional resources anonymous. The most common placement techniques include structuring<sup>6</sup> cash deposits into legitimate financial institution accounts, converting cash into other monetary instruments, and using these instruments to make investments.

**Layering** is the process of generating a series or layers of transactions in order to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include outbound electronic fund transfers, usually directly or subsequently into a "bank secrecy haven" or a jurisdiction with more liberal recordkeeping and reporting requirements, withdrawals of already-placed deposits in the form of highly liquid monetary instruments such as money orders and travelers checks, and requests for account transfers or checks made payable to third parties with whom the account-holder appears to have no obvious relationship.

**Integration**, the final money laundering stage, is the unnoticed reinsertion of successfully laundered untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions. An important placement technique is customers making large deposits and investments with laundered proceeds in the form of monetary instruments, bearer securities, or third-party checks.

.32 Money launderers tend to use the victimized business entity as a conduit for illicit funds that need to be distanced from their source as quickly as possible in an undetected manner. Consequently, it is less likely that money laundering will be detected in financial statement audits than other types of illegal activities. In addition, the activity is more likely to cause assets to be overstated rather than understated, with shorter-term fluctuations in account balances rather than cumulative changes. Thus, money laundering is considered to be an illegal act with an *indirect* effect on financial statement amounts under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

.33 Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

.34 A description of federal regulations pertaining to money laundering appears in appendix B of this Alert.

#### **Executive Summary—Money Laundering and the Auditor's Consideration of Illegal Acts**

- Money laundering is a global activity in which cash or other funds from illegal activities are funneled through legitimate businesses to conceal the initial source of funds.
- Money laundering usually results in large amounts of illicit proceeds that need to be distanced from their source as quickly as possible, and is less likely to be detected in a financial statement audit than other types of illegal activities.
- Under SAS No. 54, money laundering is considered to be an illegal act with an indirect effect on financial statement amounts. The auditor does not have a detection responsibility for such illegal acts. However, auditors should be aware of the possibility that such illegal acts may have occurred.

<sup>6</sup> "Structuring" means breaking up large amounts of currency into smaller amounts in order to conduct transactions in such a manner as to avoid suspicion and detection.



## New Audit and Attestation Standards

*What new audit and attestation standards has the AICPA issued since the last Audit Risk Alert?*

### **SAS No. 86, Amendment to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties**

.35 SAS No. 86 was issued by the Auditing Standards Board (ASB) in March 1998 to reflect the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners that have examined or reviewed Management's Discussion and Analysis (MD&A) in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special type of agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of the interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

### **SAS No. 87, Restricting the Use of an Auditor's Report**

.36 SAS No. 87 was issued by the ASB in September 1998 and is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, which elements to include in that report. The SAS states that an auditor should restrict use of the report when—

- The subject matter of the auditor's report, or the presentation being reported on, is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, and not to provide assurance on the specific subject matter of the report.

### **SSAE No. 8, Management's Discussion and Analysis**

.37 SSAE No. 8 was issued by the ASB in June 1998 and became effective upon issuance. The new attestation standard provides guidance to practitioners concerning the performance of attest engagements with respect to MD&A prepared pursuant to SEC rules and regulations. The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8—

- Sets conditions for engagement performance for both examinations and reviews of MD&A.
- Provides extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A.
- Provides a comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8.

A more comprehensive discussion of newly issued auditing literature appears in *Audit Risk Alert—1998/99* [AAM section 8010].

## Accounting Issues and Developments

### Exposure Draft—Proposed AICPA Audit and Accounting Guide *Audits of Investment Companies*

#### *What are the highlights of the proposed AICPA Audit and Accounting Guide Audits of Investment Companies?*

.38 On September 22, 1998, the Investment Companies Committee of the AICPA Accounting Standards Division issued an exposure draft of the Audit and Accounting Guide *Audits of Investment Companies* (the proposed Guide). The proposed Guide, which has not been materially revised since 1986, would supersede the AICPA Audit and Accounting Guide *Audits of Investment Companies* (with conforming changes as of May 1, 1998) (the current Guide) and SOP 93-2, *Determination, Disclosure, and Financial Statement Presentation of Income, Capital Gain, and Return of Capital Distributions by Investment Companies*. Interested parties may obtain the exposure draft from the AICPA's Web site at <http://www.aicpa.org/members/div/acctstd/edo/index.htm> and submit written comments.

.39 The proposed Guide incorporates the following authoritative material specific to investment companies:

- SOP 89-2, *Reports on Audited Financial Statements of Investment Companies*
- SOP 89-7, *Report on the Internal Control Structure in Audits of Investment Companies*
- SOP 93-1, *Financial Accounting and Reporting for High-Yield Debt Securities by Investment Companies*
- SOP 93-4, *Foreign Currency Accounting and Financial Statement Preparation for Investment Companies*
- SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*
- SOP 95-3, *Accounting for Certain Distribution Costs of Investment Companies*

The FASB did not object to the AICPA's releasing for public comment the proposed Guide at its meeting in July 1998. During its deliberations, the FASB expressed concern that the scope of the proposed Guide may not be clear. Specifically, paragraph 1.5 of the proposed Guide and of the current Guide states that, regarding venture capital investment companies, "the provisions of this Guide generally apply," while paragraph 1.6 of the proposed and current Guides lists the "attributes" of an investment company, which, when met, would require that the proposed and current Guides be applied. Those two paragraphs may be interpreted as being contradictory and may have resulted in diversity in practice. The FASB observed that the proposed Guide provides specialized accounting guidance for entities within its scope, particularly regarding the entity's reporting of investments at fair value and not consolidating the accounts of certain investees. The Chairman of the Accounting Standards Executive Committee of the AICPA (AcSEC) has acknowledged that diversity in practice exists with respect to application of the scope of the current Guide with respect to venture capital investment companies. AcSEC plans to add a separate Statement of Position project to clarify the scope of the proposed Guide. Until that project is finalized, an entity should consistently follow its current accounting policies to determine whether the provisions of the current Guide apply to investees of the entity or to the subsidiaries that are controlled by the entity. Further information may be obtained in the FASB staff announcement in the EITF Topic No. D-74, *Issues Concerning the Scope of the AICPA Guide on Investment Companies*.

.40 With certain exceptions noted in the preface to the proposed Guide, changes in accounting and reporting requirements would be applied prospectively and be effective for annual financial statements issued for fiscal years beginning after December 15, 1999, and for interim financial statements issued thereafter.

## Current AICPA Audit and Accounting Guide *Audits of Investment Companies*—1998 Conforming Changes

.41 The following list summarizes some of the revisions included in the AICPA Audit and Accounting Guide *Audits of Investment Companies* (the Guide) with conforming changes as of May 1, 1998. The Guide has been updated to reflect the following:

- Amendments to SEC Form N-1A
- Adoption of SEC rule 18f-3
- Adoption of FASB Statement No. 125
- Issuance of SAS No. 81
- Issuance of SOP 98-5, *Reporting on the Costs of Start-Up Activities*

The Guide also discusses changes in accounting and reporting practices in the areas of business combinations and supplies revised wording for the independent auditor's report for various matters.

### Application of FASB Statement No. 125

*Which FASB Statement No. 125 application issues should auditors of investment companies be aware of?*

.42 Currently, the FASB has two separate projects related to FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*:

- *FASB Special Report on the Application of FASB Statement No. 125.* Two years after the issuance of FASB Statement No. 125, FASB staff states that it continues to receive a high volume of inquiries regarding the Statement's application. Accordingly, the FASB decided to issue a special report, in question-and-answer format, to address various provisions of the Statement. An April 1998 draft report, *A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, contains eighty-four questions and answers, some of which come under the headings of scope, control criteria—isolation, effective control, secured borrowings, and collateral. A few of the topics addressed are clean-up calls, dollar roll transactions, and transferor recourse provisions. The draft report was released for purposes of obtaining feedback and warns readers that several items may change pending the outcome of the FASB's proposed interpretation or amendment of Statement No. 125.
- *Proposed Interpretation or Amendment of FASB Statement No. 125.* FASB continues to deliberate its proposal to either interpret or amend Statement No. 125. Initially, the proposed interpretation or amendment was to address the effect of the Statement on EITF Issue No. 90-18, *Effect of a "Removal of Accounts" Provision on the Accounting for a Credit Card Securitization*; however, the FASB later decided to consider defining and clarifying other issues. By midyear, FASB reached a number of tentative decisions, although these decisions are not considered final until the proposed interpretation or amendment becomes final.

Further information regarding the above projects may be obtained from the FASB's Web site at [www.fasb.org](http://www.fasb.org).

### .43 Other FASB Statement No. 125—Related Development:

- *SEC Confirmation of Accounting Treatment of Securities Collateral Received in Connection with a Securities Loan under FASB Statement No. 125.* The SEC issued a letter in late 1997, confirming the accounting treatment of securities received as collateral by an investment company in connection with a loan of its portfolio securities. The SEC no-action letter specified that when an investment company does not

have “effective control” over the securities received as collateral in connection with a loan of its portfolio securities, it is not required to record the securities received as its asset. Instead, the lent portfolio securities remain the lending company’s asset, and should continue to be reported as part of its portfolio with appropriate footnote disclosure as to the arrangement. Staff determined that the lending company did not have “effective control” per FASB Statement No. 125 because it was unable to pledge or sell the collateral received, or commingle it with other assets, and the borrower was able to terminate the loan and require the lending company to return the collateral at any time.

## Accounting for Derivative Instruments and Hedging Activities

### *How does implementation of FASB Statement No. 133 affect investment companies?*

.44 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. P16), establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. This new Statement has minimal effect on most investment companies, and for the most part, decreases the disclosure requirements imposed on them. The Statement supercedes FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance Sheet-Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It carries forward the requirement under FASB Statement No. 119 to disclose the objectives, context, and strategies for holding and issuing derivatives. Qualitative disclosures describing the overall risk management profile are encouraged, but not required. FASB Statement No. 133 eliminates the requirement to disclose the average fair value of derivatives held for trading purposes. It also eliminates the requirement under both FASB Statement Nos. 105 and 119 to disclose the face or contract amount of derivatives held at the balance sheet date although these amounts are typically disclosed in order to present details about the investments. In addition, requirements under FASB Statement No. 105 to disclose the nature and terms of financial instruments with off-balance sheet risk and the cash flow requirements associated with them are also eliminated.

.45 FASB Statement No. 133 is effective for fiscal years beginning on or after June 15, 1999, with early adoption permitted.

## SOP 98-5, Reporting on the Costs of Start-Up Activities

### *How does implementation of SOP 98-5 affect investment companies?*

.46 In April 1998, AcSEC issued SOP 98-5, *Reporting on the Costs of Start-Up Activities*. This SOP provides guidance on the financial reporting of start-up costs and organization costs, requiring these costs to be expensed as incurred.

.47 The SOP broadly defines start-up activities and provides examples to help entities identify which costs are and are not within the scope of the SOP. As noted in paragraphs 22 and 23, the SOP exempts investment companies that meet certain criteria from reporting the effect of the initial application of the SOP as a cumulative effect of a change in accounting principle. These entities should apply the SOP prospectively for all costs of start-up activities and organization costs incurred as of June 30, 1998. For these entities, costs previously deferred that continue to be reported as assets should continue to be amortized over the remaining term of the amortization period used by the entity, or a shorter period if the expected period of benefit is reduced. The unamortized balance of deferred start-up costs or organization costs and the remaining amortization period should be disclosed.

.48 A comprehensive discussion of newly issued accounting literature appears in *Audit Risk Alert—1998/99* [AAM section 8010].

## References for Additional Guidance

.49 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.

.50 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.

.51 Electronic bulletin board services and web sites 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.

.52 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.53 All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines.

.54 This Audit Risk Alert replaces *Investment Companies Industry Developments—1997/98*.

.55 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—1998/99* [AAM section 8010].

.56 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066. 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.

.57 Copies of federal documents referred to in this document are available for sale from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20401; order desk telephone: (202) 512-1800; fax: (202) 512-2250.

.58 The Audit Risk Alert *Investment Companies Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may email these comments to [callen@aicpa.org](mailto:callen@aicpa.org) or write to:

Catherine Allen, CPA  
AICPA  
Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

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## Appendix A

### Auditor Web Sites

<i>Name of Web Site</i>	<i>Content</i>	<i>Internet Address</i>
American Institute of CPAs (AICPA)	Summaries of auditing and other professional standards, legislative initiatives, and other AICPA activities	<a href="http://www.aicpa.org">http://www.aicpa.org</a>
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	<a href="http://www.fasb.org">http://www.fasb.org</a>
Securities and Exchange Commission (SEC)	SEC activities, public speeches, EDGAR filings, final and proposed rules	<a href="http://www.sec.gov">http://www.sec.gov</a>
Investment Company Institute	Site of the mutual fund industry trade association; comprehensive fund flow information; current industry, economic, regulatory, and legislative information	<a href="http://www.ici.org">http://www.ici.org</a>
U.S. Department of the Treasury	IRS tax policy, tax forms, and frequently asked questions	<a href="http://www.ustreas.gov">http://www.ustreas.gov</a>
Mutual Fund Magazine	Access to current and prior issues of <i>Mutual Fund Magazine</i> , a weekly newsletter	<a href="http://www.mfmag.com">http://www.mfmag.com</a>
Pointcast Network	Daily business news, including access to summaries of articles from, e.g., the <i>Wall Street Journal</i> , the <i>New York Times</i> , <i>Fortune</i> , and <i>Money</i> , custom-styled to the individual's interests	<a href="http://www.pointcast.com">http://www.pointcast.com</a>
Yahoo, Altavista	Two of the best known "search engines" used to "surf the Net"	<a href="http://www.yahoo.com">http://www.yahoo.com</a> <a href="http://www.altavista.digital.com">http://www.altavista.digital.com</a>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.kentis.com/ib.html">http://www.kentis.com/ib.html</a>
AMG Data Services	Up-to-date fund flow and asset information	<a href="http://www.amgdata.com">http://www.amgdata.com</a>
Rutgers Accounting Web	Search engine, accounting resources	<a href="http://rutgers.edu">http://rutgers.edu</a>

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## Appendix B

### Federal Money Laundering Regulations

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the U.S. Department of the Treasury to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties. Investment companies are defined as financial institutions under the Act (Title 31 USC 5312(a)(I)), but are not currently required to report suspicious activity either by employees or by customers to the Treasury Department, although a number of major investment companies are voluntarily complying with this provision. BSA implementing regulations require investment companies to file Currency Transaction Reports (CTRs) for cash transactions greater than \$10,000 (31 CFR 103.22). Other BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs) and foreign bank and financial accounts (FBARs) have not been modified since 1989 and 1987, respectively. However, on January 16, 1997 (see Federal Register) the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

According to the National Association of Attorneys General, thirty states have enacted legislation prohibiting money laundering. Additional states are currently considering such legislation.

On July 13, 1998 the European Union expanded the scope of Directive 91/308/EEC to require auditors and lawyers to report suspicious activity. This directive would apply to the audits of European operations and subsidiaries of domestic investment companies.

## Information Sources

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Organization	General Information	Fax/Phone Services	Web Site Address/ Electronic Bulletin Board	Recorded Announcements
American Institute of Certified Public Accountants	<i>Order Department</i> Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077  Information about the AICPA's continuing professional education program is available through the AICPA Professional Development Team: (888) 777-7077, menu item 1	24 Hour Fax Hotline (800) 362-5066	www.aicpa.org	
Financial Accounting Standards Board	<i>Order Department</i> P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	24 Hour Fax on Demand (203) 847-0700, menu item 14	www.fasb.org	Action Alert Telephone Line (203) 847-0700 (ext. 444)
U.S. Securities and Exchange Commission	<i>Publications Unit</i> 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4040 (202) 942-8092 (tty) SEC Public Reference Room (202) 942-8090	Information Line (202) 942-8088, ext. 3	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) 326-5800	www.ici.org	

[The next page is 8355.]



# AAM Section 8110

## *Securities Industry Developments—1998/99*

### In This Year's Alert . . .

- What significant industry and economic developments are relevant to the audits of broker-dealers and commodity entities?
- What are some of the final rules issued by the SEC and the CFTC during 1998?
- What are some of the audit issues caused by today's changing global marketplace?
- What is money laundering? What are the auditor's responsibilities with respect to money laundering?
- What should auditors consider when auditing trades in an "online" environment?
- What are the issues relating to the value of commodity exchange memberships?
- What are the highlights of the new Practice Aid for audits of commodity entities?
- What is the Year 2000 Issue? What industry and regulatory developments have taken place in the last year with respect to the year 2000?
- How will the European Union's adoption of a new reporting currency affect broker-dealers?
- What new audit and attestation standards has the AICPA issued in the past year?
- Which FASB Statement No. 125 application issues should the broker-dealer auditor be aware of?
- What new accounting standards has the FASB issued during 1998?

\* \* \* \*

### Industry and Economic Developments

*What significant industry and economic developments are relevant  
to the audits of broker-dealers and commodity entities?*

.01 The securities industry took a wild roller coaster ride through 1998, beginning with the continuation of an unprecedented upswing driven by the strong U.S. economy and outstanding U.S. and European stock market performance. Industry profits for the three and a half years ending in mid-1998 exceeded those of the entire six-year period ending in 1994, propelled by record levels of trading volume, underwriting activity, and expansion into fee-based businesses, such as asset management. By midsummer, however, the ride turned decidedly downward, as the Dow Jones Industrial Average (DJIA) slid lower and lower. Over a six-week period, the DJIA plunged nearly 1,800 points, or 19 percent, from its record high of 9338, driven by a chain of toppling foreign economies. Other stock market indexes reported similar drops in value. Half of those losses occurred in just three trading days. As securities prices tumbled, investors fled to the safety of U.S. Treasury securities, pushing yields to historic lows and paralyzing other components of the bond market, particularly those tied to the emerging markets and so-called "junk" bonds.

.02 The longest bull market in history—approximately eight years—preceded the 1998 stock market downturn. That extended period spurred tremendous growth in the securities industry, particularly in the last few years, as a result of the following:

- *Accelerating Commission Revenues.* Rising average daily trading volumes on the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation (NASDAQ) system generated healthy brokerage commissions. Average daily trading volumes were approximately 20 percent greater than in 1997,<sup>1</sup> and daily trading volumes that were unheard of just a few years ago became the norm in 1998. On September 1, a record-breaking 1.2 billion shares were exchanged on the NYSE; the NASDAQ posted its second-busiest day, trading almost 1.3 billion shares. Auditors may wish to consider this significantly greater trading volume when assessing control risk, as required by Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319). Additionally, a broker-dealer's internal control may not be designed to address sudden surges of trading volume, which may, in the auditor's judgment, result in reportable conditions. As defined in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325.02), reportable conditions are "significant deficiencies in the design or operation of internal control, which 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." Auditors should also be aware of their responsibilities with respect to reporting material inadequacies in internal control (identified during the course of the annual financial statement audit) pursuant to the Securities and Exchange Commission's (SEC) rule 17a-5(h)(2).
- *Strong Underwriting Revenues.* Especially strong equity underwriting activity has been the primary force behind vigorous investment banking fees. In the second quarter alone, underwriting proceeds totaled \$494.4 billion, up 57 percent from the same period in 1997, providing firms with near-record underwriting fees of \$5.25 billion in the first half of 1998.
- *Merger and Acquisition (M&A) Advisory Fees.* M&A activity has escalated steadily in the past few years, the result of competitive forces and global expansion of businesses. By midyear 1998, the value of mergers and acquisitions in the U.S. soared by 153 percent from the same point in 1997, to \$910 billion. Global M&A activity by midyear doubled to \$1.3 trillion, rapidly approaching the \$1.6 trillion record set in 1997. Such activity has fueled strong growth in firms' M&A-related advisory fees.
- *Explosive Growth in Online Brokerage.* The leading firm in discount online brokerage services, with 1.74 million of the approximately 5 million online stock and mutual fund trading accounts, reported a \$40 billion increase in customer assets between December 31, 1997, and May 1998, an increase of more than 68 percent. Other firms, both discount and full-service brokerages, have launched aggressive campaigns to attract this lucrative market, which by 2002 is expected to reach 25 million trading accounts. A discussion of the implication of online brokerage to auditors appears in the "Audit Issues and Developments" section of this Alert.

.03 As 1998 progressed, ominous economic and political news from around the globe forced firms to reconsider complex trading strategies tied to foreign debt and securities of the emerging markets of Asia, Latin America, Russia, and Eastern Europe. Hedge funds typically engage in complex trading strategies, as do broker-dealers trading in their own accounts. Such strategies, designed to "hedge" investors from changes in currency and interest rates, require traders to predict the direction of those changes. However, rapidly changing conditions in world markets rendered various trading strategies inadequate. As these investments broke down, broker-dealers and hedge fund operators struggled to meet the demand for investor redemptions and margin calls from lenders who had financed these investments, dumping their holdings and incurring huge losses. Brokers that extended credit to hedge funds were similarly affected by credit losses.

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<sup>1</sup> Statement of Auditing Standards (SAS) No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), requires that auditors use analytical procedures in the planning and review stages of all audits. Statistical information of the type shown may be useful to auditors in applying the provisions of SAS No. 56.

Firms that used leverage to make hedges magnified their losses. In September, the Federal Reserve Bank organized a \$3.6 billion private bailout for Long-Term Capital Management Fund, L.P. by a group of elite banks and brokerage firms. The huge hedge fund had an estimated \$1.25 trillion exposure to international markets, and many feared that the fund's imminent collapse would have damaged world markets further.

.04 Some of the largest banks and brokerage houses were hit hard by Russia's currency devaluation and de facto default on hundreds of millions of dollars of debt, causing those firms to significantly reduce third-quarter earnings projections. As global troubles escalated, many firms reduced their exposure to emerging markets, and others eliminated entire divisions devoted to the marketing and sales of those securities. The following table illustrates some of the currency declines experienced in various global markets:

<i>Percentage Decline in Local Currency (as Compared With the U.S. Dollar) Between 12/31/97 and 9/1/98</i>	
Brazil	44.8%
Mexico	53.4%
Malaysia	56.7%

A further discussion of the audit implications of the effects of global events on broker-dealers, such as securities valuation issues and going-concern considerations, appears in the "Audit Issues and Developments" section of this Alert.

.05 The recent trend in M&A activity of securities industry participants continued in 1998: By midyear, banks and other entities acquired more independent broker-dealers than were acquired during the entire previous decade. As recent events cut away at industry profits, analysts expect this trend to continue and perhaps even accelerate into 1999. Auditors should be alert to the possible issues that arise in consolidated entities, such as—

- *Structural Changes.* When assessing control risk, auditors should consider the impact that structural changes accompanying a combination might have on a broker-dealer's internal control. SAS No. 55 provides relevant guidance.
- *Auditor's Role as Predecessor or Successor Auditor.* The combination of entities often results in either a gain or loss of an audit client. Accordingly, auditors should be familiar with SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), which provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place.
- *Use of Debt Financing.* Auditors should scrutinize any debt financing used to effect a business combination by carefully evaluating the debt agreement to identify, among other things, whether there are any restrictive covenants, whether the debtor is complying with these covenants, and what implications may exist with respect to covenant violations.

Industry analysts predict slower stockbrokerage activity for the remainder of 1998, due to the continuing global economic crisis and weakening U.S. corporate profits. Worsening problems in emerging markets, including devaluation of various currencies, continue to cause concern over brokerage firms' exposure to the Russian, Latin American, and other fragile markets. Even though only about 10 percent of the larger firms' earnings come from the Pacific Rim, it is considered to be an important growth area, now stunted by the deepening recessions in Japan and other Asian economies. Given these factors, plus equity market volatility and extremely slow underwriting activity, industry experts predict that brokerage firms' earnings will remain under pressure until visible signs of a widespread recovery appear.

.06 Rapid advances in technology and a raft of alliances among the world's trading exchanges have radically changed the picture for the commodities industry in the past year. The futures and options business is engaged in a frantic drive to cut costs and retain clients. Shaking the industry to its very foundations is the

inexorable progression from traditional open outcry trading to electronic trading systems. In a move that highlights that phenomenon, the Commodities Futures Trading Commission (CFTC) approved the formation of a new electronic futures exchange, the Cantor Financial Futures Exchange, Inc., for computer-based trading of futures contracts of certain U. S. Treasury securities. This development may influence the value of memberships in exchanges that use open outcry trading. For a discussion of the audit implications related to the value of exchange memberships, see the "Audit Issues and Developments" section of this Alert.

.07 The volume of futures and options contracts traded bears directly on the revenues of commodity brokers. Futures and options trading amounted to 310.5 million contracts for the first half of 1998, up 15 percent compared with the first six months of 1997. If this trend in volume holds for the balance of 1998 and commission rates do not deteriorate, experts expect that commodity brokers should have record commission income for the year.

#### **Executive Summary—Industry and Economic Developments**

- The strong U.S. and European stock market performance that propelled the securities industry to record levels of underwriting and trading activity over the last several years reversed sharply after midyear as a result of widespread global economic turmoil.
- Auditors may wish to consider that sudden and significant surges in trading volume may have placed additional strain on a broker-dealer's internal control.
- Severe currency devaluation; instability in various global markets, including Russia and several Asian and Latin American nations; and bond market anomalies have caused significant losses among major brokerage firms. Barring a recovery in world securities markets, experts predict that broker-dealers will experience continued slow underwriting and trading activity in most stock and bond markets.
- Rapid changes in the commodities industry, including a shift to electronic trading environments and consolidation of several exchanges, may affect the valuation of exchange memberships. Competition is driving futures and options firms to cut costs and preserve client bases.
- If the high volume of futures and options contracts in 1998 holds through year end, the commodities industry may report record commission revenue for the year.

## **Regulatory and Legislative Developments**

*What are some of the final rules issued by the SEC and the CFTC during 1998?*

.08 The audit and reporting requirements for securities broker-dealers are regulated by rule 17a-5 under the Securities Exchange Act of 1934 (the Exchange Act). Futures commission merchants (FCMs) and broker-dealers that are also FCMs are regulated by Regulation 1.16 of the Commodity Exchange Act. Registered broker-dealers in U.S. government securities are regulated by section 405.02 of the regulations pursuant to section 15C of the Exchange Act. Before undertaking the audit of an FCM or a broker-dealer in securities, an auditor should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

## **SEC Regulations**

.09 The following is a summary of some of the rules the SEC issued during 1998:

- *Year 2000 Reports.* The SEC amended rule 17a-5 under the Securities Exchange Act of 1934 to require broker-dealers with minimum net capital requirements of \$5,000 or greater to file with the SEC and the broker-dealer's designated examining authority (DEA) two separate reports regarding their year 2000 readiness. The first report, which addresses the broker-dealer's year 2000 readiness as of July 15, 1998, was to be filed with the SEC and DEA by August 31, 1998. The second report, which addresses year 2000 readiness as of March 15, 1999, is to be filed with the SEC and DEA by April 30, 1999. With respect to the second report, the SEC requires broker-dealers with a minimum net capital requirement of \$100,000 or greater as of March 15, 1999, to file a report prepared by an independent

public accountant regarding the entity's process for addressing year 2000 problems. Year 2000 readiness reports also are required of certain nonbank transfer agents. The SEC has indicated that broker-dealers should include their SEC and CRD numbers on the accountant's report.

Auditors should refer to the full text of the releases that are available on the SEC's Web site at <http://www.sec.gov> (release nos. 34-40162 and 34-40608 for broker-dealers and release nos. 34-40163 and 34-40587 for transfer agents). See the "Audit Issues and Developments" section of this Alert for a discussion of the Year 2000 Issue and the AICPA's newly issued Statement of Position which provides guidance for practitioners performing year 2000 agreed-upon procedures attestation engagements to meet the requirements of SEC rule 17a-5 and 17Ad-18, as well as Advisories No. 17-98 and 42-98 of the Commodity Futures Trading Commission.

- *Offshore Offers and Sales.* The SEC is adopting amendments to the Regulation S safe-harbor procedures for offshore sales of equity securities of U.S. issuers and the reporting requirements applicable to those transactions. The amendments are designed to stop abusive practices in connection with offerings of equity securities purportedly made in reliance on Regulation S. Effective date: January 1, 1999.
- *Plain English Disclosure.* The SEC adopted the Plain English Rule, which requires issuers to write the cover page, summary, and risk factors section of prospectuses in plain English to give investors more clear, concise, and understandable information. Effective date: October 1, 1998.
- *Covered Securities Under Section 18 of the Exchange Act.* The SEC adopted rule 146(b) under section 18, as amended, to designate securities listed on the Chicago Board Options Exchange, Tier I of the Pacific Exchange, and Tier I of the Philadelphia Stock Exchange as covered securities for the purposes of section 18 of the Exchange Act. Covered securities under section 18 are exempt from state law registration requirements. Effective date is pending publication in the *Federal Register*.
- *Electronic Data Gathering, Analysis, and Retrieval (EDGAR) System.* The SEC is adding a rule to the series of rules governing the submission of filings and other documents through EDGAR. The SEC will not accept any paper filing that is required to be filed electronically unless the registrant satisfies the requirements for a temporary or continuing hardship exemption. Effective date: January 1, 1998.

The complete text of the above rules, along with those rules adopted subsequent to the publication of this Alert, can be downloaded from the SEC's Web site at <http://www.sec.gov>.

## CFTC Regulations

.10 The regulatory environment of the commodities industry has a major effect on the audit of a commodity entity because the auditor is required to report on the commodity entity's internal control and on its compliance with specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls may have to be performed even if the auditor would not otherwise choose to do so. Therefore, before undertaking the audit of a commodity entity, auditors should be familiar with the applicable rules issued by the CFTC pursuant to the Commodity Exchange Act (CEAct), as well as understand the prescribed scope of the audit and the related reporting requirements. Auditors should assess the effect of the regulatory environment, changes in that environment, and the expectations of their clients and regulators on both audit risk and materiality.

.11 The following is a summary of some of the final rules issued by the CFTC during 1998:

- *Futures-Style Margining of Commodity Positions.* The CFTC issued a final rule, *Final Rulemaking Permitting Futures-Style Margining of Commodity Options*, repealing CEAct Regulation 33.4(a)(2), which requires the purchaser of a commodity option to pay the full option premium at the initiation of the transaction, and amending Regulation 33.7(b), to modify accordingly the requirements of the statement to be delivered to a customer by an FCM or introducing broker (IB). Futures-style margining requires both the purchaser ("long") and the seller ("short") of a commodity option to post a risk-based, original margin upon entering into an option position. During the life of the option,

its value is marked to market daily and gains and losses are posted to the accounts of the long and short option holders. Effective date: July 17, 1998.

- *Minimum Financial Requirements for FCMs.* The CFTC issued a final rule amending its minimum financial requirements to eliminate the short option value charge taken in computing net capital. Effective date: July 16, 1998.
- *Immediate Notice of Undersegregation.* The CFTC amended its Regulation 1.12 to require an FCM to notify immediately the CFTC and the FCM's designated self-regulatory organization of any undersegregated or undersecured condition and of certain events pertaining to undercapitalization or failure to satisfy margin calls. Effective date: August 28, 1998.
- *Bundled Futures and Option Orders.* The CFTC issued a final rule allowing brokers to bundle futures and options orders for large institutional investors and for individuals with \$10 million or more in assets, a change designed to speed trading for those customers. Under the rule, futures brokers can make trades for certain eligible customers in a group and later allocate the transactions to each investor, eliminating a requirement that each order be tagged with identifying information. Effective date: August 28, 1998.
- *Year 2000 Reports.* The CFTC, in conjunction with the futures self-regulatory organizations (SROs), has followed a comprehensive and multifaceted approach to assist the futures industry in achieving year 2000 compliance. This approach includes issuing questionnaires and letters to SROs and registrants requesting detailed information regarding their year 2000 preparations, and publishing advisories that specify the year 2000 responsibilities of SROs and registrants. The CFTC also requires special year 2000-related reports and audit procedures. (See AICPA Statement of Position [SOP] 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission* for details regarding required agreed-upon procedures related to year 2000 compliance.) Effective date: September 30, 1998.

The complete text of the above rules, along with those rules adopted subsequent to the publication of this Alert, can be downloaded from the CFTC's Web site at <http://www.cftc.gov>.

## Audit Issues and Developments

### Effects of Recent Changes in the Global Marketplace on Audits of Broker-Dealers

*What are some of the audit issues caused by today's changing global marketplace?*

.12 A series of significant declines in securities and currency valuations of the Pacific Rim countries, Russia, Eastern Europe, and Latin America took hold of the U.S. markets in the third quarter of 1998, causing the DJIA to sink, slowly but surely. By late summer, the DJIA had experienced several significant single-day shifts, for example, declines of 4.19 percent on August 27 and 6.37 percent on August 31, the result of investor anxiety over worldwide economic and political turmoil. Of particular concern to investors was Russia's devaluation of the ruble, default of hundreds of millions of dollars in debt, and political instability. Another troubling event occurred in Malaysia, where the local government fixed the exchange rate of its currency, the ringgit, and imposed controls over the flow of capital outside the country. In the U.S., a consortium of banks and brokerage firms effected a \$3.6 billion takeover of Long-Term Capital Management, L.P.—a highly-leveraged hedge fund that bet heavily on emerging markets (particularly Russia) and bond yield spreads—to prevent further damage the fund might cause by liquidating its holdings.

#### Valuation Issues

.13 With these and other events at play, quoted security valuations have become more difficult to obtain in certain markets, and when valuations have been obtained, questions have arisen whether such valuations represent fair value (that is, the price at which a willing buyer and a willing seller would enter into an exchange). Issues that have arisen include—

- *Lack of Trading Activity.* Trading activity in certain markets (for example, certain bond markets, especially those of the emerging markets) has declined significantly, to the point that, in some cases, trading has effectively ceased. In these situations, the auditor should carefully evaluate any market quotations used by management in valuing securities, to gain assurance that the quotations represent current trading activity and to assess whether the market has become so stagnant that even current prices no longer represent realizable value.
- *The Effect of Significant Events Occurring During or After the Close of Foreign Markets on Securities Pricing; Trading Halts.* Most foreign markets close earlier than U.S. markets. Typically, broker-dealers value their portfolios at the time of the close of trading on the principal exchange on which the financial instruments are traded. On occasion, however, significant events may occur after the foreign market's close that would affect the valuation of those securities. Similarly, in some cases, securities markets may have imposed trading halts during periods of excessive volatility. Should such a halt have been imposed at the time a broker-dealer obtained price quotations, the quotations may not represent the current realizable value of the security at that time. Either situation may require the broker-dealer's management to substitute estimates of fair value for the affected securities determined in good faith for the last exchange quotations.
- *Credit Risk Considerations or Realizability of Estimated Investment Value.* Auditors should assess the impact of credit risk on the realizability of values assigned to non-exchange-traded financial instruments in addition to the completeness and accuracy of counterparty credit losses recorded as a result of third- and fourth-quarter market activity.
- *Other Factors.* In a market where exchange controls exist, even though market quotations for securities are readily available, the auditor should assess whether management's use of such quotes is appropriate under the circumstances. Issues to be considered in such an environment include—
  - How, when, and at what exchange rate the firm will be able to repatriate its investments.
  - The extent to which exaggerated demand for local market securities has resulted in prices being bid up by numerous investors' inability to repatriate funds.
  - The potential effect on securities prices if controls were to be lifted.
  - Other regulatory restrictions that may have made it difficult for investors to liquidate security or currency holdings.

Accordingly, the auditor should evaluate procedures applied by management in considering whether, and to what extent, local market quotations may need to be adjusted to adequately represent the value the broker-dealer would reasonably expect to receive on disposition and repatriation.

.14 Auditors should consider SEC Financial Reporting Policy (FRP) sec. 404.03-.04, chapter 7 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide), and Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), when evaluating methods employed by management in estimating fair value. Auditors may also wish to refer to the guidance set forth in SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, in evaluating management's financial statement disclosures regarding these situations. Although FASB Statement No. 107 states that quoted market prices, if available, are the best evidence of fair value of financial instruments, the economic and market conditions described in this section illustrate that, in certain situations, management's estimate of fair value as determined in good faith provides a more appropriate valuation. Paragraph 7.06 of the Guide outlines financial statement disclosures that should accompany management's reporting of a value that is lower than the quoted market price. Paragraph 7.09 states that, when the fair value as determined by management is lower than the market quotation, financial instruments should be valued at fair value. In such situations, the auditor should review management's documentation supporting its reason(s) for substituting estimates of fair value for quoted market prices. Auditors should also assess the reasonableness of the procedures used

and factors considered by management in making such estimates. Auditors should refer to the guidance of SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), in doing so.

.15 In applying SAS No. 57, auditors may wish to consider these additional factors:

- *Stock Market Volatility.* Auditors may wish to consider the impact of sudden and significant stock market fluctuations on the relevance of key factors and assumptions used by management in estimating the value of a broker-dealer's security portfolio. Worldwide stock market volatility and instability have been the most widespread and severe seen in several years. Domestically, during the third quarter, the DJIA gained or lost at least 100 points in ten of twelve consecutive trading sessions, and intrasession swings have surprised even the experts. Some foreign exchanges have experienced far greater volatility. In the event that the broker-dealer employs matrix pricing (a mathematical technique used to value normal institutionalized debt securities without relying exclusively on quoted securities prices), the auditor should evaluate the relevance of the model's existing underlying assumptions to determine whether they are consistent with recent economic and industry developments.
- *Adoption of New Trading Strategies.* Growth, competitive forces, and changing global factors have caused some broker-dealers to adopt new trading strategies that include the use of more speculative, complex, or innovative investments. The adoption of new trading strategies often brings about new valuation procedures that cause factors different from those previously considered by the auditor to become significant to the estimate. Because of the inherent difficulties in valuing such investments, auditors may wish to consider obtaining written representation from management (AU sec. 342.09) and using the work of a specialist (SAS No. 73, *Using the Work of a Specialist* [AICPA, *Professional Standards*, vol. 1, AU sec. 336]). As stated in SAS No. 73, complex or subjective matters that are potentially material to the financial statements may require special skill or knowledge that, in the auditor's judgment, requires using the work of a specialist to obtain competent evidential matter.

.16 Auditors should also consider whether declining valuations might have resulted in possible regulatory infractions, such as the following:

- *Transfers of Capital by U.S. Broker-Dealers to Meet Losses of Offshore Affiliates.* As stated in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, SEC rule 15c3-1 restricts the withdrawal of equity capital, the repayment of subordinated obligations, and the making of any unsecured advance or loan to an affiliate.
- *Credit Extensions by Foreign Affiliates of Domestic Broker-Dealers That Extend High-Margin Loans to a Nonregulated Environment.* Such foreign affiliates are generally exempt from Regulation T requirements, which prohibit such transactions.

.17 In addition to regulatory considerations, auditors may also wish to consider the possibility that rapid economic and political changes in emerging markets in which firms had significant investments, or with which firms had material credit relationships, may have caused some broker-dealers serious issues, such as:

- *Going-Concern Considerations.* Although larger firms may be able to absorb losses incurred by steep declines in the values of their stock portfolios, or from funding or liquidity problems, smaller and medium-sized firms may not, thus raising possible going-concern issues. Information that raises doubt about the going-concern assumption for broker-dealers includes (1) failure to meet statutory net capital requirements, (2) noncompliance with various other rules and regulations, and (3) substantial disposition of assets outside the ordinary course of business. Auditors should also consider that changes in key financial ratios caused by the stock market's decline may trigger repayment clauses contained in debt covenants or bank-imposed limits on credit due to the decline in the value of a firm's portfolio. In these circumstances, auditors should consider the guidance set forth under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341).



- *Restructuring Charges, Asset Impairment Write-Downs, Improper Accruals, and Estimated Liabilities.* During the third and fourth quarters, several major securities firms announced layoffs and restructurings of operations resulting from substantial losses sustained as a result of emerging-market positions (for example, Russia, Latin America, Asia) and counterparty positions (for example, hedge funds). Auditors should be aware that the SEC staff has expressed concerns regarding the appropriate accounting for these situations.
- *Risk of Material Misstatement Arising From Fraudulent Financial Reporting.* The severe downward shift in stock prices, coupled with continuing, intense competition in the securities industry, increases the risk of fraudulent financial reporting. For example, a firm's management responsible for losses sustained in its portfolios might misstate financial information or misappropriate assets to mitigate the effects of those losses. Relevant guidance is set forth in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

**Executive Summary—Effects of Recent Changes in the  
Global Marketplace on Audits of Broker-Dealers**

- Significant declines in securities and currency valuations throughout the world, particularly those of several emerging markets, have caused various issues for auditors of broker-dealers, including valuation, regulatory, and going-concern issues.
- Valuation issues created by the lack of trading activity in certain markets, the effect of significant events occurring after the close of foreign markets, trading halts, credit risk, and other factors require auditors to carefully consider management's good faith securities valuations.
- In evaluating management's good faith securities valuations, auditors should consider SAS No. 81, *Auditing Investments*, and SAS No. 57, *Auditing Accounting Estimates*. Auditors may also wish to consider whether certain economic factors and industry trends, such as increased stock market volatility, management's adoption of new trading strategies, substantial mark-to-market write-downs on equity and debt positions, counterparty credit losses, and restructuring charges have significantly affected the key factors and assumptions management uses in valuing securities.

## Money Laundering Activities and the Auditor's Consideration of Illegal Acts<sup>2</sup>

*What is money laundering?*

*What are the auditor's responsibilities with respect to money laundering?*

.18 Money laundering is the funneling of cash or other funds generated from illegal activities through legitimate businesses to conceal the initial source of the funds. Money laundering is a global activity and, like the illegal activities that give it sustenance, it seldom respects local, national, or international jurisdiction. Current estimates of the size of the global annual "gross money laundering product" range from \$300 billion to \$1 trillion.<sup>3</sup>

.19 Criminals use bank and nonbank financial institutions and professional advisers to launder the proceeds of crime, and according to the U.S. Department of the Treasury, brokers and dealers in securities may also be vulnerable. The evolving dynamics of the industry—mergers and acquisitions, broader product lines, and new distribution channels—generate important business opportunities, but they also generate risks for securities firms and their auditors, including increased vulnerability to money laundering. As these industry trends continue, as money launderers increasingly look for a wide range of financial services and conservative, legitimate-appearing asset holdings, and as greater regulatory requirements for banks and other nonbank financial institutions make it more difficult for them to evade detection, the securities industry may become more attractive to money launderers.

<sup>2</sup> The U.S. Department of Treasury has had significant input in drafting the content of this section of the Alert. As such, it provides auditors of broker-dealers with a unique insight into how federal regulators view this important area of concern.

<sup>3</sup> By definition, money launderers are in the business of cloaking their activities and revenue, making this approximation difficult.

.20 While money laundering activity and methods become increasingly complex and ingenious, its “operations” tend to consist of three basic stages or processes—placement, layering, and integration.

**Placement** is the process of transferring the actual criminal proceeds, whether in cash or in any other form, into the financial system in such a manner as to avoid detection by bank and nonbank financial institutions and government authorities. Money launderers pay careful attention to national laws, regulations, governance, trends, and law-enforcement strategies and techniques to keep their proceeds concealed, their methods secret, and their professional resources anonymous. The most common placement techniques include structuring<sup>4</sup> cash deposits into legitimate financial institution accounts, converting cash into other monetary instruments, and using these instruments to make investments.

**Layering** is the process of generating a series of or layers of transactions to distance the proceeds from their illegal source and to obfuscate the audit trail in doing so. Common layering techniques include outbound electronic funds transfer, usually directly or subsequently into a “bank secrecy haven” or a jurisdiction with more liberal recordkeeping and reporting requirements; withdrawals of already-placed deposits in the form of highly liquid monetary instruments, such as money orders and travelers checks; and requests for account transfers or checks made payable to third parties with whom the account holder appears to have no obvious relationship.

**Integration**, the final money laundering stage, is the unnoticed reinsertion of successfully laundered, untraceable proceeds into an economy. This is accomplished through a wide variety of spending, investing, and lending techniques and cross-border, legitimate-appearing transactions. An important placement technique is customers’ making large deposits and investments with laundered proceeds in the form of monetary instruments, bearer securities, or third-party checks.

.21 Money launderers tend to use the victimized business entity as a conduit for illicit funds that need to be distanced from their source as quickly as possible in an undetected manner. Consequently, money laundering is less likely to be detected in a financial statement audit than other types of illegal activities. In addition, the activity is more likely to cause assets to be overstated rather than understated, with shorter-term fluctuations in account balances rather than cumulative changes. Thus, money laundering is considered to be an illegal act with an *indirect* effect on financial statement amounts under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts may have occurred. If specific information comes to the auditor’s attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

.22 Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication of cases.

.23 A description of federal regulations pertaining to money laundering appears in the appendix of this Alert.

#### **Executive Summary—Money Laundering Activities and the Auditor’s Consideration of Illegal Acts**

- Money laundering is a global activity in which cash or other funds from illegal activities are funneled through legitimate businesses to conceal the initial source of funds.
- Money laundering usually results in large amounts of illicit proceeds that need to be distanced from their source as quickly as possible and is less likely to be detected in a financial statement audit than other types of illegal activities.
- Under SAS No. 54, money laundering is considered to be an illegal act with an indirect effect on financial statement amounts. The auditor does not have a detection responsibility for such illegal acts. However, auditors should be aware of the possibility that such illegal acts may have occurred.

<sup>4</sup> *Structuring* means breaking up large amounts of currency into smaller amounts to conduct transactions in such a manner as to avoid suspicion and detection.

## Online Brokerage

*What should auditors consider when auditing trades in an “online” environment?*

.24 In the past few years, the number of online brokerage accounts in the United States has skyrocketed, with some analysts speculating that online brokers handle some 25 percent of all investor trades. Though plagued with stalls and breakdowns due to abnormally heavy trading volume on October 27 and 28, 1997, record-breaking surges in trading activity in 1998 resulted in only a few minor complaints, proving that online systems had been significantly enhanced.

.25 Embraced mostly by discount brokerage firms, the main difference between an online trade and a traditional trade is the lack of a middleman, that is, the customer, instead of a broker, types in the order for an online trade. In both forms of trading, an order is entered into the computer system, which then transports it to a stock exchange or NASDAQ for execution. In these situations, traditional source documents, such as purchase orders, invoices, and checks, have been replaced by electronic communications. Auditors should carefully consider the internal controls related to these communications as well as the nature and sufficiency of available evidential matter underlying trading transactions.

.26 SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically.

.27 When audit evidence exists only in electronic form, the SAS provides that—

- Consideration should be given to when electronic evidence will be available in determining the nature, timing, and extent of substantive audit procedures because electronic evidence that is not maintained or “backed up” may be irretrievable after a certain period of time.
- Sole reliance upon substantive procedures to reduce detection risk to an acceptable level may not be possible in certain situations in which significant information is transmitted, processed, maintained, or accessed electronically. Accordingly, performing tests of controls to obtain evidence when assessing control risk is appropriate.

A common misconception associated with SAS No. 31 is that it requires auditors to perform tests of controls for computer systems that handle material transactions. This is not a requirement of the SAS, but rather a matter left to the auditor’s professional judgment. The SAS does indicate that, in certain circumstances in which evidential matter exists in electronic form, the auditor may determine that it would not be practicable or possible to reduce detection risk to an acceptable level by performing only substantive tests. SAS No. 31 provides that in such cases, the auditor should perform tests of controls to support an assessed level of control risk below the maximum for affected assertions.

.28 The AICPA Auditing Practice Review (APR) *The Information Technology Age: Evidential Matter in the Electronic Environment* provides auditors with nonauthoritative guidance on implementing SAS No. 31. The APS describes electronic evidence and its implications and presents two case studies that illustrate various audit approaches. Other relevant APSs include *Audit Implications of EDI* and *Audit Implications of Electronic Document Management*. Auditors may also wish to obtain additional information from the Information Systems Audit and Control Association’s Web site at <http://www.isaca.org>.

## Value of Commodity Exchange Memberships

*What are the issues relating to the value of commodity exchange memberships?*

.29 During the past year, the value of a membership in every major U. S. commodity exchange decreased significantly, continuing a trend of the past several years. Although those decreases do not affect regulatory

net capital, because exchange memberships are excluded from the calculation, the decreases do raise concerns about the value of such assets reported in generally accepted accounting principles (GAAP) financial statements.

.30 Accounting for commodity exchange memberships should be the same as that used by broker-dealers for memberships in securities exchanges. When addressing valuations of exchange memberships, auditors should evaluate management's consideration of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, I08). FASB Statement No. 121 states that a significant decrease in the market value of an asset indicates that the recoverability of the carrying value of that asset should be assessed. It further states that quoted market prices in active markets are the best evidence of fair value and should be used as the basis of measurement, if available. Exchange memberships are bought and sold continuously. Paragraph 7.34 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* advises that "exchange memberships owned by broker-dealers should be valued at cost or a lesser amount if there is an other-than-temporary impairment in value [emphasis added]." The AICPA Audit Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* describes the same accounting treatment (a description of the new Practice Aid follows this discussion). In light of the information shown in the following table, the auditor may wish to consider whether management has valued exchange memberships appropriately.

Exchange	Peak Price	Date	December 1997	Recent Price	Date	Percent Decrease (%)
Chicago Board of Trade	\$857,500	May 11, 1997	\$724,950	\$440,000	September 29, 1998	39.3
Commodity Exchange, Inc.	\$147,000	May 26, 1995	\$ 93,000	\$ 62,000	September 25, 1998	33.3
Chicago Mercantile Exchange	\$925,000	August 18, 1994	\$466,667	\$320,000	September 17, 1998	31.4
Coffee, Sugar, Cocoa Exchange*	\$225,000	June 3, 1998	\$180,000	\$117,000	September 4, 1998	35.0
New York Cotton Exchange*	\$125,000	April 2, 1998	\$125,000	\$ 81,000	September 29, 1998	35.2
New York Mercantile Exchange	\$705,000	January 20, 1998	\$675,000	\$500,000	September 22, 1998	25.9

### **New Audit Practice Aid: *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools***

*What are the highlights of the new Practice Aid for audits of commodity entities?*

.31 The AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (the Practice Aid) was issued to assist preparers of financial statements of commodity entities and their auditors in preparing and auditing such financial statements.

.32 The Practice Aid describes industry accounting and reporting practices, such as—

- *Accounting for Commodity Pools' Commission Expenses.* Such expenses can be accounted for in one of two ways: (1) on a full round-turn basis for closed pools and pools that do not expect many new

\* Coffee, Sugar, Cocoa Exchange (CSCE) and New York Cotton Exchange (NYCE) merged to form the Board of Trade of the City of New York on June 10, 1998. Those holding seats at the time of the merger were entitled to payments: \$100,000 for CSCE members and \$25,000 for NYCE members.

participants, and (2) on a half-turn basis for public pools that have many new and withdrawing participants.

- *Reporting for Commodity Pools That Invest in Other Commodity Pools.* The CFTC staff advises that, as described in the Practice Aid, commodity pools that invest in other commodity pools (fund of funds) should report in financial statement notes: (1) for each material investee pool, the carrying value in the investor's financial statements, and the liquidity of such investment (such as how often interests may be redeemed and the period of time that must elapse between giving notice and receiving redemption proceeds); and (2) summary income statement information in the detail required by CFTC rule 4.22(e) of the CEAAct (including the proportionate share of fees in dollars paid by investees to commodity pool operators and commodity trading advisers).

.33 The Practice Aid also discusses such matters as—

- *Industry Background Information.* Such information includes participants in the commodities industry, commodity markets, regulatory agencies, commodity exchanges, and other self-regulatory organizations.
- *The Role of the FCM.* The Practice Aid describes the role of the FCM in such areas as trade execution, clearance and settlement, reconciliation and balancing, and custody of customer funds.
- *Regulatory Environment.* The Practice Aid discusses significant rules and reporting requirements of the CFTC.
- *Illustrative Financial Statements.* The Practice Aid contains sample financial statements, along with supplementary schedules and notes, for a typical FCM and for a commodity pool.
- *Auditing Considerations.* The Practice Aid addresses the unique aspects of auditing commodity entities as they relate to internal control, using the work of internal auditors, analytical procedures, and accounting estimates, as well as substantive audit procedures for various transaction cycles.
- *Accounting Standards.* The Practice Aid includes the accounting model, statement-of-financial-condition and statement-of-income considerations.

The above publication may be obtained from the AICPA's Order Department by calling (888) 777-7077 or by faxing a request to (800) 362-5066.

## The Year 2000 Issue

*What is the Year 2000 Issue? What industry and regulatory developments have taken place in the last year with respect to the year 2000?*

.34 Some twenty years ago, the cost of computer memory space was exorbitant—\$600,000 per megabyte compared with about ten cents today. For this reason, many computer programs were designed using a two-digit format to represent year data; for example, 1998 is coded as "98." Without proper modification, many of these systems may fail to process year-related data accurately beyond the year 1999, a chilling thought in today's global computer information age. Hence, the Year 2000 Issue has become one of the most often discussed business topics of the past few years.

.35 The AICPA has been active in creating awareness of the Year 2000 Issue among its members and the public and providing guidance to auditors regarding their responsibilities in audits leading up to the year 2000. The SEC and industry trade groups, such as the Securities Industry Association (SIA), have taken proactive roles in guiding investment and other companies in their preparations for the year 2000. Some of the efforts of these organizations are as follow:

- The AICPA has published articles, books, and other materials on the Year 2000 Issue. A comprehensive discussion of the numerous auditing and accounting issues related to the Year 2000 Issue is pre-

sented in the AICPA publication "The Year 2000 Issue—Current Accounting and Auditing Guidance." This publication is being updated for recent developments and is available free of charge at the AICPA's Web site at <http://www.aicpa.org>. The AICPA also has added to its Web site the Year 2000 Resource Page, which contains useful links to various year 2000 sites and publications.

- The Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB) issued three new audit interpretations specifically related to the Year 2000 Issue.
- The SEC spearheaded several initiatives to promote year 2000 readiness and has amended rule 17a-5 under the Exchange Act to require broker-dealers to file copies of two separate reports with the SEC and their designated examining authority at designated times, regarding their year 2000 compliance (see also the "Regulatory and Legislative Developments" section in this Alert). In August, the SEC further issued *Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisors, Investment Companies, and Municipal Securities Issuers* (the Interpretation). The Interpretation—
  - Provides guidance to companies so they can determine whether their year 2000 issues are known material events, trends, or uncertainties that should be disclosed in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) section of their disclosure documents.
  - Sets forth SEC guidance regarding specific matters for companies to address in their MD&A year 2000 disclosure.
  - Addresses the need for companies to consider the Year 2000 Issue in connection with other rules and regulations when they prepare financial statements.
  - Reminds registrants that the antifraud provisions of the federal securities laws apply to disclosure about the Year 2000 Issue.
  - Cautions companies making year 2000 disclosures to avoid boilerplate disclosure that may not be meaningful to shareholders.

The Interpretation can be viewed on the SEC's Web site, <http://www.sec.gov/rules/concept/33-7558>.

**.36** Additionally—

- The SIA's Year 2000 Committee conducted preliminary tests during which it practiced executing and settling trades of stocks, options, mutual funds, unit investment trusts, and mortgage-backed securities. The success rate was estimated to be about 90 percent.
- The AICPA's Security Industry's Year 2000 Agreed-Upon Procedures Task Force issued SOP 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission*. The SOP provides guidance to independent accountants to identify selected characteristics of the process planned by broker-dealers to assess, remediate, test, and monitor their year 2000 readiness.

**.37** Auditors should be aware of the many auditing and accounting considerations that arise out of the Year 2000 Issue, including audit planning, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. A more comprehensive discussion of these considerations can be found in the *Audit Risk Alert—1998/99* [AAM section 8010] (also referred to as the "General Alert").

**.38** Additional information relating to the Year 2000 Issue is available on the Internet at the following Web sites:

- The Securities Industry Association (SIA)—[http://www.sia.com/year\\_2000/index.html](http://www.sia.com/year_2000/index.html)
- The National Bulletin Board for the Year 2000—<http://www.year2000.com>

- Management Support Technology—<http://www.mstnet.com/year2000>

#### Executive Summary—The Year 2000 Issue

- The Year 2000 Issue is an important one for all companies, requiring major modifications of most companies' computer systems to prevent the failure of systems to recognize year-related data beyond 1999.
- The SEC, AICPA, and industry trade groups, such as the Securities Industry Association, have taken various measures to guide broker-dealers and their auditors in their preparations for the year 2000.
- SOP 98-8 contains guidance to independent accountants engaged to perform agreed-upon procedures attestation engagements pursuant to rules 17a-5 and 17Ad-18 of the Securities Exchange Act of 1934, and Release Nos. 17-98 and 42-98 of the CFTC regarding year 2000 readiness.
- Auditors should be aware of the many auditing and accounting considerations that arise out of the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, revenue and expense recognition, and disclosure.

### Europe's New Reporting Currency, the Euro

*How will the European Union's adoption of a new reporting currency affect broker-dealers?*

.39 On January 1, 1999, the European Union's Economic and Monetary Union (EMU) goes into effect and exchange rates between "legacy currencies"—currencies of the eleven European nations that thus far constitute the EMU—and the Euro, will be permanently set. On that date, all operations of the European Central Bank, as well as new issues of government debt, will be denominated in the Euro. A phase-in period will extend to January 1, 2002, for all monetary transactions (for example, payroll and bank accounts), and June 30, 2002, will be the last day on which to withdraw legacy currencies.

.40 The introduction of the Euro is a major economic event, yet some broker-dealers may have underestimated the amount of consideration and resources needed to properly deal with the conversion due to their preoccupation with year 2000. Accordingly, auditors should consider the greater risks that may be associated with the conversion. Broker-dealers interact with a myriad of intermediaries, including other brokers, clearing organizations, depositories, and transfer agents, and will be accounting for the simultaneous conversion of Euro currencies with these various parties within a very brief period. Even good planning and execution will likely result in a large number of unreconciled items immediately following the initial conversion. Auditors may want to also consider possible increased audit risks related to internal control, foreign-currency transactions, and fraud risk factors related to the redenomination.

.41 The SEC issued Staff Legal Bulletin No. 6, which reminded broker-dealers to consider their disclosure obligations in connection with the conversion, including—

- Known trends and uncertainties that the broker-dealer expects will have a material impact on revenues, expenses, or income from continuing operations.
- Competitive implications.
- Associated costs of the conversion (through July 1, 2002).
- Ability to make timely updates of required information.
- Currency exchange rate risk and derivatives exposure.
- Continuation of material contracts.
- Potential tax consequences.

.42 In Treasury Decision 8776, the Internal Revenue Service (IRS) issued a temporary regulation indicating that conversion of legacy currencies to the Euro will generally be considered a tax-neutral event for U.S. taxpayers. Accordingly, gains or losses would not be triggered solely as a result of the conversion of taxpayer-held legacy currencies to the Euro and the conversion of legacy currency-denominated contracts, financial instruments, and other claims or obligations. However, otherwise applicable rules regarding the realization of gains or losses will continue to apply, for example, gains or losses incurred as a result of receipt of an unscheduled, fractional principal payment on a debt instrument due to a rounding convention or the modification of the indices of a floating-rate debt instrument. A final IRS regulation is expected before year end.

.43 The FASB's Emerging Issues Task Force (EITF) discussed Topic No. D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union (EMU)*, which resulted in issuance of the following staff announcements:

- *Accounting Treatment of Costs to Upgrade or Replace Internal Use Computer Software and Costs to Make Physical Modifications to Fixed Assets to Accommodate the Introduction of the Euro.* The FASB staff believes that not all such costs necessarily should be expensed as incurred (as stated in the consensus of EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*). The staff believes that those costs should be accounted for in accordance with the entity's existing accounting policies for similar costs and also reminded practitioners that in March 1998, the AICPA issued SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.
- *Preparation of Comparative Financial Statements for Periods Before the Introduction of the Euro on January 1, 1999.* The SEC staff stated that it would not object if an SEC registrant presents comparative financial statements in Euros for periods before January 1, 1999, by recasting previously reported financial statements into Euros using the exchange rate between the Euro and the prior reporting currency as of January 1, 1999 (a position that is consistent with that of the European Commission). Auditors should also consider SEC regulation S-X, Rule 3-20(e), *Currency of Financial Statements of Foreign Private Issuers*, which requires a registrant to recast its financial statements as if the newly adopted currency had been used since at least the earliest period presented. The staff interpreted this provision to require a methodology consistent with FASB Statement No. 52, *Foreign Currency Translation*; that is, the income statement and statement of cash flows should be translated into the new reporting currency using weighted average exchange rates for the applicable periods, and assets and liabilities should be translated using exchange rates at the end of the applicable periods.
- Financial statements reported in Euros by recasting based on the January 1, 1999, exchange rate will depict the same trends and relationships among a registrant's accounts as those previously reported prior to the introduction of the Euro. To decrease the likelihood that investors will inappropriately assume that the financial statements of various registrants that report in Euros are comparable, each page of the basic financial statements should indicate that prior-year balances were restated into Euros using the January 1, 1999, exchange rate. In addition, the notes to the financial statements should disclose—
  - The reporting currency that was previously used.
  - The methodology used to restate prior-year balances.
  - The exchange rate as of January 1, 1999.
  - A statement that the comparative financial statements reported in Euros depict the same trends as would have been presented had the company continued to present financial statements in the currency previously used.
  - A statement that the financial statements for periods before January 1, 1999, will not be comparable to the financial statements of other companies that report in Euros and that restate amounts from a currency different from the one previously used by the company.



.44 The EITF also discussed foreign currency translation adjustments related to the Euro's introduction. Auditors are advised to review the full text of the EITF Abstract related to Topic No. D-71 for further information.

#### **Executive Summary—Europe's New Reporting Currency, the Euro**

- On January 1, 1999, the European Union's Economic and Monetary Union (EMU) becomes effective and exchange rates between the currencies of eleven European nations and the Euro will be irrevocably fixed, a major economic event for broker-dealers.
- SEC Staff Legal Bulletin No. 6 reminds broker-dealers to consider various disclosure obligations related to the conversion, such as known trends and uncertainties that the broker-dealer expects to have a material impact on revenues, expenses, or income from continuing operations and associated costs of the conversion.
- The IRS has issued a temporary regulation indicating that conversion of legacy currencies (those of the eleven nations constituting the EMU) to the Euro will generally be considered a tax-neutral event.
- The EITF has discussed various issues related to the redenomination, including accounting for internal use computer software, comparative financial statements, and foreign currency translation adjustments.

### **New Audit and Attestation Standards**

*What new audit and attestation standards has the AICPA issued in the past year?*

#### **SAS No. 86**

.45 SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), was issued in March 1998 to reflect the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners that have examined or reviewed MD&A in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special type of agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of the interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

#### **SAS No. 87**

.46 SAS No. 87, *Restricting the Use of an Auditor's Report*, was issued in September 1998 and is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, which elements to include in that report. The SAS states that an auditor should restrict use of a report when—

- The subject matter of the auditor's report, or the presentation being reported on, is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or an other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, and not to provide assurance on the specific subject matter of the report.

### SSAE No. 8

.47 SSAE No. 8, *Management's Discussion and Analysis*, was issued in March 1998 and became effective upon issuance. The new attestation Standard provides guidance to practitioners concerning the performance of attest engagements with respect to MD&A prepared pursuant to SEC rules and regulations. The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8—

- Sets conditions for engagement performance for both examinations and reviews of MD&A.
- Provides extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A.
- Provides a comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8.

.48 For a comprehensive summary of auditing pronouncements issued this year, see the *Audit Risk Alert—1998/99* [AAM section 8010].

## AICPA Accounting and Auditing Literature

### *Audit and Accounting Guide*

.49 The AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* has been modified to include certain changes necessary due to the issuance of authoritative pronouncements through May 1, 1998. Some of these changes include: FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of FASB Statement Nos. 87, 88, and 106 (FASB, *Current Text*, vol. 1, sec. P16 and P40); EITF Consensuses adopted through the February 1998 EITF meeting; SOP 98-5, *Reporting on the Costs of Start-Up Activities*; and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333).

## Accounting Issues and Developments

### Application of FASB Statement No. 125

*Which FASB Statement No. 125 application issues should the broker-dealer auditor be aware of?*

.50 FASB currently has two separate projects related to FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Current Text*, vol. 1, F38):

- *FASB Special Report on the Application of FASB Statement No. 125.* Two years after the issuance of FASB Statement No. 125, FASB staff state that they continue to receive a high volume of inquiries on the Statement's application. On September 30, 1998, FASB published a special report that addresses the most frequently asked questions about Statement No. 125. The report, containing seventy questions and answers that affect a broad range of companies and financial institutions, is designed as an aid to understanding and implementing the Statement and is the first of several reports planned. FASB expects to publish the second report near year end.
- *Proposed Interpretation or Amendment of FASB Statement No. 125.* FASB continues to deliberate its proposal to either interpret or amend FASB Statement No. 125. Initially, the proposed Interpretation or amendment was to address the effect of the Statement on EITF Issue No. 90-18, *Effect of a "Removal of Accounts" Provision on the Accounting for a Credit Card Securitization*; however, the FASB later decided to consider defining and clarifying other issues. By midyear, the FASB reached a number of tentative decisions, although these decisions are not considered final until the proposed Interpretation or amendment becomes final.

Further information regarding the above projects may be obtained from the FASB's Web site at [www.fasb.org](http://www.fasb.org).

**.51 Other FASB Statement No. 125—Related Developments:**

- *SEC Confirmation of Accounting Treatment of Securities Collateral Received in Connection With a Securities Loan Under FASB Statement No. 125.* The SEC issued a letter in late 1997, confirming the accounting treatment of securities received as collateral by a broker-dealer in connection with a loan of its portfolio securities. The SEC no-action letter specified that when a broker-dealer does not have "effective control" over the securities received as collateral in connection with a loan of its portfolio securities, the broker-dealer is not required to record the securities received as its asset. Instead, the lent portfolio securities remain the lending company's asset and should continue to be reported as part of its portfolio with appropriate footnote disclosure on the arrangement. The staff determined that the lending company did not have "effective control" per FASB Statement No. 125 because it was unable to pledge or sell the collateral received or to commingle it with other assets, and the borrower was able to terminate the loan and require the lending company to return the collateral at any time.
- *Amended Interpretation.* The AITF has amended the Interpretation "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertions That a Transfer of Financial Assets Has Met the Isolation Criteria in Paragraph 9(a) of Statement of Financial Accounting Standards No. 125" of SAS No. 73, *Using the Work of a Specialist* (AU sec. 9336.01-.18). Issued in February 1998, the Interpretation provides guidance regarding the use of a legal specialist's findings as audit evidence to support management's assertion that a transfer of financial assets meets the legal isolation criterion of paragraph 9(a) of FASB Statement No. 125. The Interpretation addresses when the use of a legal specialist's work may be appropriate; factors that should be considered in assessing the adequacy of a legal response; and the use, as audit evidence, of legal responses that are restricted to the client's use. The Interpretation is effective for auditing procedures related to transactions required to be accounted for under FASB Statement No. 125 that were entered into on or after January 1, 1998. The AITF has amended the Interpretation to include the form of letter that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion as well as sample language that does not adequately communicate such permission. The amended interpretation appeared in the October 1998 *Journal of Accountancy*.
- *Topic No. D-66.* The EITF discussed Topic No. D-66, "Effect of a Special-Purpose Entity's Powers to Sell, Exchange, Repledge, or Distribute Transferred Financial Assets under FASB Statement No. 125," which resulted in issuance of the following FASB staff announcement:

The FASB staff believes that a special-purpose entity (SPE) that has limited powers to sell, exchange, repledge, or distribute (collectively referred to as "sell") transferred financial assets under specified conditions can be qualifying (assuming that the other criteria in paragraph 26 of FASB Statement No. 125 are met) if those powers are in response to a cleanup call as defined in FASB Statement No. 125, or if all four of the following criteria are met:

1. The powers and the conditions or events that give rise to the sale must be specified and limited permanently by the legal documents that establish the SPE or create the beneficial interests.
2. The transferor does not maintain effective control over the assets transferred. Effective control exists (a) where the transferor or its affiliates can trigger the condition that enables the SPE to sell the transferred assets and (b) where the event causing the transfer of the assets back to the transferor is probable of occurrence, unless there would be significant adverse consequences to the transferor or its affiliates under (a) and (b).
3. The primary objective of the powers is not to realize a gain in the fair value of the transferred assets over the fair value at the date of transfer to the SPE. In addition, assets may not be sold to maximize the return to beneficial interest holders.
4. The powers do not permit active or frequent selling and buying of assets.

The transition provisions of the announcement are complex and include a provision for a nonqualifying SPE to be cured if it made changes to comply with the requirements specified in the preceding paragraphs by March 31, 1998. The SEC has stated that a nonqualifying SPE will be required to be consolidated if the SPE's activities clearly did not meet the limited activities requirement of paragraph of FASB Statement No. 125 at any time after December 31, 1996.

- The above is summary information only of the EITF discussion of Topic No. D-66. Auditors are advised to review the full text of the EITF abstract.

## New FASB Pronouncements

*What new accounting standards has the FASB issued during 1998?*

.52

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of FASB Statement Nos. 87, 88, and 106, was issued in February 1998 and revises disclosure requirements for employers' pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. The new Statement standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable and eliminates certain disclosures formerly required under FASB Statement No. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16), FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, P16), and FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40). FASB Statement No. 132 requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis. The effective date is fiscal years beginning after December 15, 1997, with early application encouraged.
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, was issued in June 1998 and establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. FASB Statement No. 133 supersedes FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*. It carries forward the requirement under FASB Statement No. 119 to disclose the objectives, context, and strategies for holding and issuing derivatives. Qualitative disclosures describing the overall risk management profile are encouraged but not required. FASB Statement No. 133 eliminates the requirement to disclose the average fair value of derivatives held for trading purposes. It also eliminates the requirement under both FASB Statement Nos. 105 and 119 to disclose the face or contract amount of derivatives held at the balance sheet date, although these amounts might be disclosed to present details about the investments. In addition, requirements under FASB Statement No. 105 to disclose the nature and terms of financial instruments with off-balance-sheet risk and the cash-flow requirements associated with them are also eliminated. The effective date is fiscal years beginning on or after June 15, 1999, with early adoption permitted.

For a comprehensive summary of accounting pronouncements issued this year, see the *Audit Risk Alert—1998/99* [AAM section 8010].

## References for Additional Guidance

.53 Further information on matters addressed in this 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.

.54 Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine; others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

.55 Electronic bulletin board services and Web sites allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

.56 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.57 All telephone numbers listed are voice lines, unless otherwise designated as fax (f) or data (d) lines.

.58 This Audit Risk Alert replaces *Securities Industry Developments—1997/98*.

.59 Auditors should also be aware of the economic, industry, regulatory, and professional developments that may affect the audits they perform, as described in *Audit Risk Alert—1998/99* [AAM section 8010].

.60 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066. 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.

.61 Copies of federal documents referred to in this document are available for sale from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20401; order desk telephone: (202) 783-3238; Fax: (202) 512-2250.

.62 The Audit Risk Alert *Securities Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may email these comments to [callen@aicpa.org](mailto:callen@aicpa.org) or write to:

Catherine Allen, CPA  
AICPA  
Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

## Appendix

### Federal Regulations Related to Money Laundering

The Bank Secrecy Act (BSA), enacted to address the problem of money laundering, authorizes the U.S. Department of the Treasury to issue regulations requiring financial institutions to file reports, keep certain records, implement anti-money laundering programs and compliance procedures, and report suspicious transactions to the government (see 31 CFR Part 103). Failure to comply with BSA reporting and recordkeeping provisions may result in the assessment of severe penalties. BSA defines brokers or dealers "registered with the SEC under the Securities Exchange Act of 1934" as financial institutions and, separately, "brokers and dealers in securities and commodities." All securities brokers and dealers in the U.S. are required under 17 CFR 240.17a-8 and 17 CFR 405.4 to comply with certain anti-money laundering requirements. The most recent change to these was referenced in NASD-R Notice to Members 96-67 (see the next paragraph) regarding recordkeeping for transmittals of funds. In addition, the New York Stock Exchange, in Information Memorandum 89-5, provided information to its members on reporting suspicious transactions involving money laundering to the government (suspicious activity reporting is discussed in the following paragraphs).

NASD-R Notice to Members 96-67, *Bank Secrecy Act Recordkeeping Rule for Funds Transfers and Transmittals of Funds* provides information to National Association of Securities Dealers members regarding the Treasury's amendments to the BSA, which facilitate tracing funds through the funds-transmittal process, effective May 28, 1996. For transmittals of funds of \$3,000 or more, brokers and dealers of securities are required to obtain and keep certain specified information concerning the transmitter and the recipient of those funds. In addition, broker and dealers must include this information on the actual transmittal order.

Brokers and dealers of securities firms that are not subsidiaries of bank holding companies are not currently required under BSA to report suspicious activity either by employees or by customers to the Treasury Department. However, many securities firms are voluntarily complying with this provision, in anticipation of imminent rules. Securities subsidiaries of bank holding companies are required to report suspicious activity by the Federal Reserve (12 CFR 225). The Annunzio-Wylie Anti-Money Laundering Act of 1992 provides a safe harbor from civil liability for reporting financial institutions.

BSA implementing regulations require financial institutions including securities firms to file currency transaction reports (CTRs) for cash transactions greater than \$10,000.

Other BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs) and foreign bank and financial accounts (FBARs) have not been modified since 1989 and 1987, respectively. However, on January 16, 1997 (see *Federal Register*), the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

According to the National Association of Attorneys General, thirty states have enacted legislation prohibiting money laundering. Additional states are currently considering such legislation.

On July 13, 1998, the European Union expanded the scope of Directive 91/308/EEC to require auditors and lawyers to report suspicious activity. This directive would apply to the audits of the European operations and subsidiaries of domestic clients.

**Information Sources**

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Organization	General Information	Fax Services	Web Site Address/ Electronic Bulletin Board	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077  Information about the AICPA's continuing professional education program is available through the AICPA Professional Development Team (menu item 1).	24 Hour Fax Hotline (800) 362-5066	www.aicpa.org	
Financial Accounting Standards Board	Order Department PO Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	24 Hour Fax on Demand (203) 847-0700, menu item 14	www.fasb.org	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 (202) 942-8092 (tty) SEC Public Reference Room (202) 942-8090	Information Line (202) 942-8088, ext. 3	www.sec.gov	Information Line (202) 942-8088
Securities Industry Association	120 Broadway New York, NY 10271-0080 (212) 608-1500	(212) 608-1604	http://www.sia.com	
New York Stock Exchange, Inc.	Eleven Wall Street New York, NY 10005 (212) 656-3000	(212) 656-2126	http://www.nyse.com	
National Association of Securities Dealers, Inc.	1735 K Street, NW Washington, DC 20006-1500 (202) 728-8000		http://www.nasd.com	

(Continued)

## Information Sources (cont'd)

Organization	General Information	Fax Services	Web Site Address/ Electronic Bulletin Board	Recorded Announcements
Public Securities Association (The Bond Market Association)	40 Broad Street New York, NY 10004-2373 (212) 809-7000	(212) 440-5260	<a href="http://www.psa.com">http://www.psa.com</a>	
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	<a href="http://www.cftc.gov">http://www.cftc.gov</a>	
Futures Industry Association	2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006-1807 (202) 466-5460	(202) 296-3184	<a href="http://www.fiafii.org">http://www.fiafii.org</a>	
National Futures Association	200 West Madison Street Suite 1600 Chicago, IL 60606-3447 Information Center (312) 781-1410		Inquiries via Email: <a href="mailto:inquiry@nfa.futures.org">inquiry@nfa.futures.org</a> or <a href="mailto:public_affairs@nfa.futures.org">public_affairs@nfa.futures.org</a>	

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# AAM Section 8120

## *Not-for-Profit Organizations Industry Developments—1999*

### In This Year's Alert . . .

- How have not-for-profit organizations been affected by overall economic and industry developments? How will these developments affect audits of not-for-profit organizations?
- Have there been any updates to single audit guidance in the last year that auditors of not-for-profit organizations should be aware of?
- Have there been any updates to the OMB Cost Circulars that auditors may need to be aware of? What are the auditor's responsibilities with respect to the OMB Cost Circulars as part of a single audit?
- Has the AICPA issued any nonauthoritative guidance for implementing Circular A-133?
- Are any of the illustrative reports from SOP 98-3 available in an electronic format?
- What recent changes have been made by HUD with respect to its programs that affect audits of not-for-profit organizations?
- Are there any recent or upcoming revisions to GAS?
- How does the Religious Liberty and Charitable Donation Protection Act of 1998 affect not-for-profit organizations and their auditors?
- What are some of the current tax issues that may affect audits of not-for-profit organizations?
- What new guidance has been issued with respect to restricted-use reports and how will this affect audits of not-for-profit organizations?
- What are some of the areas of concern when applying analytical procedures in audits of not-for-profit organizations?
- What types of issues should auditors of not-for-profit organizations be aware of with respect to client fraud?
- What are some of the issues auditors should be aware of with respect to the use of volunteers and the application of the Volunteer Protection Act of 1997?
- Why are exchange transactions of increasing importance to not-for-profit organizations and their auditors?
- What issues should the auditor consider when the not-for-profit organization client has posted audited financial statements on the Internet?
- What is the Year 2000 Issue and how will it affect audits of not-for-profit organizations?
- What are some of the issues that auditors should consider with respect to the client's ability to continue as a going concern?
- What new guidance should auditors of not-for-profit organizations be aware of with respect to attestation engagements?

- What new guidance has been issued with respect to start-up activities?
- What new guidance has been issued with respect to accounting for joint activities, and what issues have resulted from the new guidance?
- What new developments have occurred with respect to accounting for related entities of not-for-profit organization clients?
- What recent activity has taken place with respect to the FASB's business combinations project, and what is the significance of this issue to not-for-profit organizations?
- What is the status of the FASB's project with respect to not-for-profit organizations that raise contributed resources for others?

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## Economic and Industry Developments

*How have not-for-profit organizations been affected by overall economic and industry developments? How will these developments affect audits of not-for-profit organizations?*

.01 The U.S. economy has continued to grow and economic conditions continue to be favorable. Among the economic indicators that reflect the depth of the economy's strength are the following:

- The U.S. jobless rate is at 4.2 percent and some economists expect it to go below 4 percent, which has not happened since the late 1960s.
- Wages rose by more than 3 percent in real terms in 1998 and may continue to increase in 1999 if labor markets continue to tighten.
- Inflation remained low (1.6 percent) in 1998 and is expected to approximate 2 percent in 1999.
- Gross domestic product (GDP), the broadest measure of total national output, grew 3.9 percent in 1998, matching its 1997 performance. The economy has not grown faster since the 7 percent rise in 1984.

Data available from the Foundation Center show 1998 giving from foundations to not-for-profit organizations increased 22 percent over 1997 figures, to \$19.46 billion. However, foundations are only a small piece of total giving, which added up to \$143.5 billion in 1997.<sup>1</sup> Indicators that giving from other sources, such as individuals, bequests, and corporations, may show an increase for 1998 include the strong economy and rising incomes.

.02 However, not all types of organizations tend to be affected equally from changes in giving. For example, for 1997, international affairs organizations saw an increase of 15 percent, whereas arts, culture, and humanities reported a decline of almost 3 percent. Because the auditor may look at the events in the economy and the industry as part of his or her analytical procedures, it is important to understand the differences in the way such events affect different clients. For example, the auditor may need to evaluate why the results achieved by the client are not consistent with industry averages. See the section titled "Analytical Procedures" for a further discussion.

.03 Also, after the sharp drop in the Dow Jones Industrial Average in the summer of 1998, there was some question about whether the three-year span of record-breaking fund-raising results would be affected by the stock market's volatility. (A more recent question is whether the Dow's breaking the 10,000 mark will

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<sup>1</sup> Based on estimate from *Giving USA*; figures are revised as more information becomes available.

affect giving patterns.) Some charities reported that donors delayed gifts of stock and cut back on cash contributions in 1998, although results for 1998 are still expected to equal those of 1997. One reason for the delay in gifts of stock, which account for approximately one-quarter of donations, is that donors waited to see if the stock market would recover. Because many not-for-profit organizations receive 20 percent to 30 percent of their contributions in the fourth quarter of the calendar year, this delay was of particular concern. Fluctuations in giving may also cause concern for auditors. For example, not-for-profit organizations may have an incentive to hold back the reporting of promises to give in one period to keep some that can be reported during a period of decreased contributions. Auditors may want to consider issues such as this when evaluating the risk of material misstatement due to fraud. See a further discussion in the section titled "Consideration of Fraud in a Financial Statement Audit."

.04 In addition to making contributions of assets, people also contribute their time and effort as volunteers. The importance of being able to supervise volunteers properly may not be so apparent to some not-for-profit organizations; however, the consequences of poorly supervised or trained volunteers can be devastating for a not-for-profit organization. A further discussion of this issue is included in the section titled "Acts of Volunteers."

.05 Auditors should also be aware of new forms of contributions (such as the use of charitable split-dollar life insurance), as well as increases in contributions of assets other than cash (such as the recent increase in contributions of real estate). Not-for-profit organizations may also have new sources of income, such as revenue from joint marketing ventures with for-profit companies. Auditors may need to consider audit implications resulting from shifts in revenue sources. For example, contributions of real estate can result in various issues, such as environmental-compliance issues or clean-up costs that will be incurred, possible tax implications, the organization's ability to manage income-producing property before its disposition and maintain its value, and the need to hire appraisers to value the contribution.

.06 As not-for-profit organizations find new ways to raise funds, clients and auditors often face questions about whether these transactions are contributions, exchange transactions, or a combination of both. See a further discussion of this issue in the section titled "Exchange Transactions." Additionally, there may be tax consequences resulting from new or shifting revenue sources. See a further discussion in the section titled "IRS Activities."

.07 An issue that is becoming more pressing for some not-for-profit organizations is the increase in competition from for-profit businesses. Although not-for-profit organizations have been accustomed to such competition from such entities as for-profit hospitals, day-care centers, and trade and technical schools, changes in the way that government entities administer certain social programs are resulting in new areas of competition. Even though governments previously focused on not-for-profit organizations as the recipients of social services contracts, they are now outsourcing a greater part of their social service functions to for-profit businesses, in areas such as welfare-to-work programs, foster care programs, juvenile corrections, and special education. Auditors may need to address the potential effects of these policy shifts on the entity's ability to continue as a going concern, which is discussed further in the section titled "Going-Concern Issues."

.08 Not-for-profit organizations are using the Internet for fund-raising, providing newsletters and updates, thanking donors, answering questions, building a base of subscribers, inviting people to their events, negotiating and receiving contributions, holding online auctions, selling products, advertising and delivering program services, participating in affinity programs, meeting Internal Revenue Service (IRS) disclosure requirements, and other activities. A number of these uses can affect the internal control environment of the not-for-profit organization client. Auditors should ensure that they have a sufficient understanding of the organization's internal control to plan and perform the audit. Auditors should refer to the guidance in Statement on Auditing Standards (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 Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

.09 With the increased use of the Internet, not-for-profit organizations may also be posting more financial information on their Web sites. One reason is the new disclosure rules enacted to make Form 990 more easily available to the public (see the section titled "IRS Activities"). As a result of the new disclosure rules, the public should be able to obtain Form 990 more easily, and some not-for-profit organizations may need to pay more attention to the accuracy with which this form is prepared. Some common errors found in not-for-profit organizations' filings include:

- Failing to file a complete Schedule A.
- Failing to complete Schedule A Support Schedule.
- Using the incorrect tax year at the top of page one.
- Failing to complete balance sheets for both years and the required schedules.
- Failing to sign the return.

.10 Publicity about such shortcomings may have an adverse effect on the not-for-profit organization. Combined with negative media articles about not-for-profit organizations, such as stories about misuse of funds by not-for-profit organizations, errors in tax filings available for public view can lead to questions about the not-for-profit organization's ability to manage its finances and could ultimately lead to a decrease in confidence and in contributions. As mentioned in the section "Going-Concern Issues," auditors should be alert to such negative developments.

.11 In addition to posting Form 990 on the Internet, some not-for-profit organizations are posting their financial statements on the Internet, raising additional issues for the auditor. See the section titled "Financial Statements on the Internet" for a discussion of this issue.

.12 International events can also affect not-for-profit organizations. On January 1, 1999, the European Economic and Monetary Union (EMU) went into effect. Under the EMU, only one reporting currency will exist—the euro. Every entity that trades with or has subsidiaries in Europe will be affected by the change to a common currency. This may affect entities with foreign-currency transactions or foreign operations involving the euro. A discussion of this issue is included in *Audit Risk Alert—1998/99* [AAM section 8010].<sup>2</sup>

.13 Also, 1998 brought us yet another year closer to the Year 2000 Issue. Problems resulting from the millenium bug may have significant effects on the client, and implications for the audit. See the section titled "The Year 2000 Issue" for a further discussion.

#### **Executive Summary—Economic and Industry Developments**

- It appears that the current economic expansion will continue to provide strong increases in giving in some, but not all, areas of the not-for-profit community.
- Despite the strong economy, some economic changes can lead to concerns about such matters as client fraud and the ability of the entity to continue as a going concern.
- Increased Internet activity is raising many issues, from internal control to public scrutiny.
- 1999 brought us another year closer to the year 2000 problem and the potential problems that can result.

<sup>2</sup> The *Audit Risk Alert—1998/99* [AAM section 8010] (Product No. 022223) provides a general update on economic, auditing, and accounting matters. The *Audit Risk Alert—1999/2000* will be available later in 1999.

## Regulatory and Legislative Developments

.14 Auditors of not-for-profit organizations may need to monitor changes in government regulations for various reasons. For example, they may be required to comply with government auditing standards, as specified in the *Government Auditing Standards* (also referred to as the Yellow Book).<sup>3</sup> In addition, auditors may be required to perform a “single audit” and comply with applicable rules. A single audit is an audit of an entity’s federal financial assistance, as required by the Single Audit Act Amendments of 1996 (the Act), and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133).<sup>4</sup> Not-for-profit organizations may also be affected by other federal, state, and local laws, such as laws regulating the registration of not-for-profit organizations and tax laws affecting their tax-exempt status.

### Single Audit Guidance Update

*Have there been any updates to single audit guidance in the last year that auditors of not-for-profit organizations should be aware of?*

### 1999 Compliance Supplement Revisions Issued

.15 The *Compliance Supplement* (the Supplement) is based on the requirements of the Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. It serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Act and Circular A-133.

.16 In May 1998, the OMB issued the 1998 OMB Circular A-133 Compliance Supplement (1998 Supplement), which was effective for audits of fiscal years beginning after June 30, 1997. It superseded the June 1997 Provisional Supplement and is available on the OMB’s Web site and from the Government Printing Office (GPO) (Stock No. 41-001-0057-2). For the eighty-five programs included in the 1998 Supplement, information is included to assist auditors in understanding the federal program’s objectives, procedures, and compliance requirements. Part 7 of the Supplement, “Programs Not Included in This Supplement,” provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included in the Supplement.

.17 Keeping its commitment to update the Supplement on a regular basis and to continue to expand the number of programs included in it, the OMB has issued a 1999 Supplement. The 1999 Supplement adds approximately thirty-five additional federal programs and provides updates and revisions to existing programs. Some of the more significant changes in the 1999 Supplement are—

- Removal of the reference to the separate U.S. Department of Housing and Urban Development (HUD) Supplement for Housing Authorities. HUD had previously issued interim guidance to address the unique requirements of audits of Public and Indian Housing Authorities in the “Public and Indian Housing Compliance Supplement for Annual Audits of Public Housing Agencies and Indian Housing Authorities by Independent Auditors.” With the 1999 revision to the Supplement, this interim guidance is no longer applicable. The programs in the existing HUD supplement have either been added to the 1999 Supplement or will be covered by Part 7 of the Supplement.
- An addition to Part 3, “Compliance Requirements,” under “N. Special Tests and Provisions,” to clarify the auditor’s responsibility to test for compliance with the year 2000 problem in computer systems.

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<sup>3</sup> Although government auditing standards primarily apply to federal financial assistance, some states have adopted government auditing standards.

<sup>4</sup> Instead of a single audit, under certain circumstances, program-specific audits may be conducted.

A notice of availability of the 1999 Supplement was published in the May 17, 1999 *Federal Register*. A printed copy can be obtained from the GPO (Stock Number 041-001-00522-6) after May 28, 1999. The OMB will also be posting an electronic copy of the 1999 Supplement on the OMB Web site at <http://www.whitehouse.gov/OMB>, under the "Grants Management" heading.

### ***Data Collection Form Instructions Clarified***

.18 Submission of the data collection form is a key part of completing a single audit.<sup>5</sup> This form assists the federal government in accumulating information regarding the thousands of single audits that are performed. The Federal Audit Clearinghouse (FAC) is the entity that is responsible for receiving data collection forms and report submissions. It is also responsible for maintaining the database of completed reports. During 1998, the FAC processed approximately 22,000 Circular A-133 audits and related data collection forms. The database of the forms is accessible on the FAC Web site at <http://harvester.census.gov/sac>.

.19 The information required to be included in the data collection form represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards. Circular A-133 requires the auditee to complete and sign certain sections of the form that state whether the audit was completed in accordance with Circular A-133. Further, information is required to be provided about the auditee, its federal programs, and the results of the audit. The auditor is also required to complete certain sections of the data collection form, including information on the results of the financial statement audit and the audit of the federal programs. It is important for both the auditor and auditee to follow carefully the detailed instructions that accompany the form.

.20 Unfortunately, most forms submitted in 1998 were rejected the first time they were processed due to errors in the information provided. As a result, in November 1998, the FAC revised the instructions to the form to provide clarifications for the most frequent causes of rejection. Copies of the new instructions, along with an extra copy of the form, were mailed to every auditor and auditee that submitted a form in the prior year. No changes have been made to the data collection form itself. A copy of the revised instructions, along with the form, can be found on the FAC Web site or on the OMB's Web site at <http://www.whitehouse.gov/OMB>. If auditors or auditees have any questions on completing the form, they should contact the FAC at (301) 457-1551.

.21 Although there has been a reduction in the frequency of errors, the FAC continues to report certain common problems with the forms that they are receiving. The FAC staff do not test the data provided on the data collection form. However, edit checks are built into the processing system to detect common errors. For example, if an item is not filled out completely or if an answer in one part of the form is not consistent with a similar answer in another part, the form is rejected. When this occurs, the FAC returns the form to the auditee with instructions on why the form was rejected. The auditee is responsible for correcting the form, including signing it again (resignature). Resignature by the auditor is also required if Part II or III is affected. If the auditee does not resubmit a rejected form correctly to the FAC, the FAC records will indicate that the auditee has not complied with the Circular A-133 audit requirement. The following information details some of the continuing problems noted by the FAC and is included to help auditors and auditees avoid making similar errors in future submissions.

.22 ***Dollar Threshold to Distinguish Between Type A and Type B (Part III, Item 2, of the Form).*** Many auditors have erroneously indicated a dollar threshold of less than \$300,000. This is incorrect because the floor for the threshold is \$300,000. Some auditors have also mistakenly indicated two thresholds. Others have

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<sup>5</sup> The data collection form and related instructions are available from the Federal Audit Clearinghouse (FAC) in various word-processing packages (that is, Microsoft Word and WordPerfect). These electronic versions of the form are available from the FAC Web site at <http://harvester.census.gov/sac>. Auditors are not permitted to create their own electronic version of the form. The form and instructions can also be obtained from the OMB's Web site at <http://www.whitehouse.gov/OMB>. A printed copy can also be obtained from the FAC at (888) 222-9907. The form number is SF-SAC. The FAC is also currently working on a process for electronic submission. Auditors can follow developments on this project by periodically reviewing the FAC Web site.

mistakenly indicated no threshold. In responding to this part of the form, the auditor should include the result of Step 1 in the risk-based approach (described in section .520(b) of Circular A-133). The dollar amount should always be \$300,000 or more.

**.23 Federal Agencies Required to Receive the Reporting Package (Part III, Item 5, of the Form).** Only federal agencies affected by audit findings should be identified as needing to receive a copy of the reporting package (described in section .320(d) of Circular A-133). If no federal agency is required to receive a copy of the reporting package, the auditor should mark "None." Auditees must send the FAC one reporting package for each federal agency identified in Part III, Item 5, plus one archival copy for the FAC. For example, consider an auditee that has four federal awards that were received directly from four federal agencies. Further, assume that the current-year single audit resulted in audit findings on one of the four federal awards and that the summary schedule of prior audit findings included the status of a prior-year finding related to a second federal award that had no current-year audit findings. In this example, the auditee would be required to submit three reporting packages to the FAC—one for the FAC to retain as an archival copy, one for the federal agency that provided federal awards that had current-year findings associated with them, and one for the federal agency where the summary schedule of prior audit findings reported the status of a prior-year finding.

**.24** A common error has been for auditors to mark all federal agencies that provided funding, regardless of whether there were audit findings from awards provided directly by the federal agency. Another common error has been to mark "Commerce" because the FAC is a part of the Department of Commerce. "Commerce" should be marked only if there are audit findings relating to Commerce programs. As a result, reports were sent to the FAC that were not needed, causing an unnecessary paper flow from the auditee to the FAC and certain federal agencies.

**.25 CFDA Number (Part III, Item 6(a), of the Form).** Failure to include the Catalog of Federal Domestic Assistance (CFDA) number has also caused many rejected reports. Auditees should consult with their federal awarding agency or pass-through entity to obtain the CFDA number. For research and development programs that do not have a CFDA number, the auditor should enter the federal agency's two-digit prefix (as listed in appendix 1 of the data collection form instructions) followed by a period and the letters "RD." For example, a Department of Health and Human Services (HHS) research program would be entered as "93.RD." For other programs that do not have a CFDA number, the auditor should enter the federal agency's two-digit prefix (as listed in appendix 1 of the data collection form instructions). For example, an HHS program would be entered as "93." Alternately, if a contract number is available (such as 99999) the auditor could enter the CFDA number as "93.99999."

**.26 Audit Findings and Questioned Costs (Part III, Item 7, of the Form).** This section of the data collection form must be completed in its entirety for every audit under Circular A-133, regardless of whether audit findings and questioned costs were noted. Also, question 7(b) asks the auditor to identify the types of compliance requirements. Auditors should note that the only types of compliance requirements that should be listed are those requirements with audit findings (including questioned costs) associated with them. Some auditors have been incorrectly listing all requirements that were tested for a particular program. If no audit findings are noted, question 7(b) should be answered with the letter "O."

**.27 Cognizant or Oversight Agency for Audit (Part 1, Item 9, of the Form).** Only recipients expending more than \$25 million a year in federal awards are assigned a cognizant agency for audit. Because this threshold is so large, most auditees have only an oversight agency for audit. Sections .400(a) and .400(b) of Circular A-133 provide guidance on determining the cognizant or oversight agency for audit. Most often, the federal awarding agency provides the predominant amount of direct funding. Cognizant assignments are established every five years. For purposes of the data collection form, the auditee should identify only one federal agency as the cognizant or oversight agency for audit. Further, the cognizant or oversight agency for audit is always a federal agency, and a pass-through entity should not be identified as a cognizant or oversight agency for audit.

### Executive Summary—Single Audit Guidance Update

- The OMB has issued a 1999 revision to the *OMB Circular A-133 Compliance Supplement*.
- The instructions to the data collection form have been clarified in an attempt to help auditees and auditors fill out the form correctly, so the form is not rejected by the FAC.
- The FAC continues to find problems—although in somewhat reduced numbers—with the data collection forms that are being submitted.
- Auditors should review the continuing problems with the data collection form to help avoid making similar errors in future submissions.

## President's Council on Integrity and Efficiency Audit Review Guides Expected

.28 It has been almost two years since sweeping changes were made to the rules for single audits. The OMB has recently communicated its desire to the Inspector General (IG) community for more information about the quality of the audits that are being performed. As a result, a significant increase in the number of desk reviews and quality control reviews performed by IGs is expected during the next several years. To assist the IGs in performing these reviews, the President's Council on Integrity and Efficiency (PCIE) Audit Committee is expected to issue a revised initial review guide and quality control review guide by mid-1999. The guides are being updated to reflect the new single audit rules and will be available upon their completion on the IG Web site at <http://www.ignet.gov>.

.29 Among other things, the initial review guide is used by the IGs as part of a quality control review in assuring that the audit reports issued in a single audit meet applicable reporting standards and Circular A-133 reporting requirements. The quality control review guide is used by the IGs as a tool in assuring that the audits are conducted in accordance with applicable standards and meet single audit requirements. They are both used to identify whether any follow-up audit work is needed.

.30 Upon issuance, auditors should consider reviewing the updated guides to gain an understanding of what the IGs will be looking for in their reviews to help ensure that their engagements meet the criteria identified.

## OMB Cost Circulars Update

*Have there been any updates to the OMB Cost Circulars that auditors may need to be aware of? What are the auditor's responsibilities with respect to the OMB Cost Circulars as part of a single audit?*

.31 Auditors involved with audits of federal awards to not-for-profit organizations and colleges and universities should be aware that the OMB issued revisions to Circular A-122, *Cost Principles for Nonprofit Organizations*, in May 1998, and to OMB Circular A-21, *Cost Principles for Educational Institutions*, in October 1998. The revisions were published in the June 1, 1998, and the October 27, 1998, *Federal Register* and the recompiled Circulars are posted on the OMB Web site at <http://www.whitehouse.gov/OMB/grants/index.html>. The comparison of the various OMB cost principles Circulars included in the 1999 Supplement has been updated for the 1998 Circular changes (see Part 3 of the Supplement).

.32 The 1998 changes to OMB Circular A-21 include establishing a review process for large research facilities, establishing a utility cost adjustment, clarifying the computation of use allowance and depreciation, and allowing the trustee's travel expenses.

.33 The 1998 changes to OMB Circular A-122 include raising the equipment capitalization threshold to \$5,000, revising the multiple allocation basis methodology to compute indirect cost rates, and adding unallowable costs to be consistent with other OMB cost principles Circulars.



.34 The various OMB Cost Circulars applicable to not-for-profit organizations (for example, Circular A-122 and Circular A-21) describe selected cost items, allowable and unallowable costs, and standard methodologies for calculating indirect cost rates. The following describes the auditor's responsibilities with regard to the various OMB Cost Circulars in a single audit.

.35 In addition to the auditor's responsibilities under *Government Auditing Standards* (GAS) and under SAS No. 54, *Illegal Acts of Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), of generally accepted auditing standards (GAAS), related to compliance, Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs (herein referred to as compliance requirements). A single audit results in the auditor expressing an opinion on the auditee's compliance with these compliance requirements for each of its major programs. Part 3 of the *Compliance Supplement* lists and describes the fourteen types of compliance requirements and the related audit objectives that the auditor should consider in every audit conducted under Circular A-133, with the exception of program-specific audits performed in accordance with a federal agency's program-specific audit guide. One of the types of compliance requirements that the auditor is required to consider is allowable costs/cost principles. Part 3 of the *Compliance Supplement* states that the audit objective for allowable costs/cost principles is for the auditor to determine whether the organization complied with the provisions of the applicable OMB Cost Circulars. Part 3 also provides suggested audit procedures for testing allowable costs/cost principles. Auditors should refer to the *Compliance Supplement* for further information.

## Two OMB Circular A-133 Delayed Implementation Provisions Become Effective in 1999

.36 When Circular A-133 was originally issued in 1997, the OMB allowed a delayed implementation for two provisions. Auditors performing Circular A-133 audits should be aware that these provisions become effective in 1999.

.37 The first provision relates to the timing of the submission of the reporting package and data collection form by the auditee to the FAC. The Circular originally required this submission to be made within the earlier of thirty days after receipt of the auditor's reports or thirteen months after the end of the audit period. However, for fiscal years beginning after June 30, 1998, the submission must be made within the earlier of thirty days after receipt of the auditor's reports or nine months after the end of the audit period. Auditors should consider whether this change could affect the timing of the audit. For example, a report for the fiscal year ending June 30, 1999, would be due the earlier of thirty days after receipt of the auditor's report or March 31, 2000.

.38 The second provision relates to a restriction on auditors who prepare indirect cost proposals or cost allocation plans. For audits beginning after June 30, 1998, those auditors may not also be selected to perform the Circular A-133 audit if the indirect costs recovered by the auditee exceeded \$1 million. This restriction applies to the base year used in the preparation of the indirect proposal or cost allocation plan and to any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. For example, an auditor who prepares an indirect cost proposal or cost allocation plan that is used as the basis for charging indirect costs in the fiscal year ending June 30, 1999, is not permitted to perform the 1999 single audit (assuming that the indirect costs recovered during the prior year exceeded \$1 million).

## Guidance for Implementing OMB Circular A-133

*Has the AICPA issued any nonauthoritative guidance for implementing Circular A-133?*

.39 The AICPA Practice Aid *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations* (Product No. 008730)<sup>6</sup> to

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<sup>6</sup> Generally accepted auditing standards (GAAS) requirements are discussed in the Practice Aid to the extent that they are necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, and relevant AICPA Audit and Accounting Guides, such as *Not-for-Profit Organizations*, *Health Care Organizations*, and *Audits of State and Local Governmental Units*, for additional information.

provide auditors of states, local governments, and not-for-profit organizations that receive federal awards with nonauthoritative practical guidance on auditing and reporting on single audits and program-specific audits under—

- The Single Audit Act Amendments of 1996.
- Circular A-133.
- The 1994 revision of *Government Auditing Standards*, issued by the comptroller general of the U.S. General Accounting Office (GAO). *Government Auditing Standards* incorporate GAAS issued by the AICPA.

**.40 The Practice Aid—**

- Presents and discusses the contents of the Single Audit Act Amendments of 1996, OMB Circular A-133, and the provisional A-133 *Compliance Supplement*. (See the next paragraph for note.)
- Discusses issues relating to procuring audit services for a Circular A-133 audit.
- Discusses the planning of the single audit and the selection of major programs using the Circular A-133-mandated risk-based approach.
- Discusses audit procedures relating to internal control and compliance.
- Discusses the reporting requirements for a single audit.
- Discusses the Circular A-133 requirements for conducting and reporting on a program-specific audit.
- Presents a comprehensive case study that applies the Circular A-133 requirements to an illustrative auditee.
- When applicable, refers the reader to additional guidance in GAAS; GAS; and Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.
- Is provided with a companion booklet that includes additional materials, such as checklists and sample reports.

Note that the Practice Aid was published before the OMB's issuance of the 1998 and 1999 *Compliance Supplements*. Readers of the Practice Aid should review appendix V of the 1998 and 1999 *Compliance Supplements* (which list the changes in each year's Supplement) and any other pronouncements that may affect matters addressed in the Practice Aid.

## **Illustrative Single Audit Information Available on AICPA Web Site**

*Are any of the illustrative reports from SOP 98-3 available in an electronic format?*

**.41** The AICPA has made the illustrative auditor's reports from appendix D of SOP 98-3 available on the AICPA web site at <http://www.aicpa.org/belt/a133main.htm>. These illustrations can either be viewed or downloaded. It should be noted that the electronic versions of the illustrative reports have been updated for the issuance of SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See the related discussion in the section of the Audit Risk Alert titled, "New Auditing Standards."

**.42** In addition to the electronic auditor's reports, the AICPA has also included other electronic single audit information on its Web site at the address above. For example, electronic versions of the illustrative schedules of expenditures of federal awards and schedule of findings and questioned costs from appendixes C and E of SOP 98-3 are included. Also, a listing of unofficial frequently asked questions and answers regarding Circular A-133 is included to assist auditors.

## Housing and Urban Development Programs

*What recent changes have been made by HUD with respect to its programs that affect audits of not-for-profit organizations?*

.43 HUD has published revised Uniform Financial Reporting Standards for HUD Housing Programs (see *Federal Register*, September 1, 1998) to establish uniform annual financial reporting standards for HUD's public housing, section 8 housing, and multifamily insured housing programs. The rule requires not-for-profit, for-profit, and public housing agency project owners of HUD-assisted housing (which already, under longstanding regulatory and contractual requirements, submit financial information on an annual basis to HUD) to submit this information electronically to HUD. The rule also requires that the annual financial information submitted to HUD be prepared in conformity with generally accepted accounting principles (GAAP).

.44 Except for public housing agencies (which are discussed separately in the rule), the requirement of electronic submission of GAAP-based audited financial reports begins for covered entities with fiscal years ending December 31, 1998, and later.

.45 The audited financial statements would be required in accordance with the Act and Circular A-133. (See the related discussion titled "Two OMB Circular A-133 Delayed Implementation Provisions Become Effective in 1999.") However, not-for-profit project owners will have to submit the required unaudited GAAP financial reports, with accompanying information as required by HUD, within the sixty days after their fiscal year end, in accordance with the existing requirements of their HUD regulatory agreement or contract.

.46 In a January 1999 letter to project owners, HUD granted a one-time submission extension to the normal sixty-day financial reporting requirement for all projects having fiscal year ends between December 31, 1998, and March 31, 1999. Those multifamily housing projects have until June 30, 1999, to complete the first required electronic submission of their annual financial statement information. Submission extensions for projects with fiscal year ends after March 31, 1999, may be requested through the Financial Assessment Subsystem (the new electronic reporting system), after May 31, 1999.

.47 HUD has also established a new HUD Real Estate Assessment Center (REAC). REAC was established to—

- Set and apply uniform financial reporting standards for HUD's multifamily housing programs, including a standard chart of accounts and supplemental compliance data, and annual audits of financial statements prepared in conformity with GAAP.
- Provide for electronic submission and processing of annual financial statement information and essential supplemental compliance data.
- Design and apply objective financial performance and compliance measures.
- Advise HUD's limited program monitoring and enforcement staff of acceptable housing program performers that need little or no further attention.
- Refer unacceptable financial performance and compliance indicators for possible program intervention or enforcement action by HUD's field office program staff or newly created Enforcement Center.

Extensive information regarding the activities of REAC and how they affect HUD programs and audits of HUD programs is available on the REAC Web site at <http://www.hud.gov/reac>. Further assistance on the electronic submission requirements is available by contacting the REAC Customer Service Center at (888) 245-4860.

## Department of Education Issues Questions and Answers Document

.48 The U.S. Department of Education (DE) Office of the Inspector General released a document, *Questions and Answers on OMB Circular A-133 As It Relates to U.S. Department of Education Programs*, to assist auditors in performing audits of certain DE programs in accordance with Circular A-133. The document is available on the Education Department/Office of the Inspector General Non-Federal Audit Team Web site at [http://home.gvi.net/~edoig/a133q\\_a.doc](http://home.gvi.net/~edoig/a133q_a.doc). The questions address such issues as testing institutional eligibility, preparing the Schedule of Expenditures of Federal Awards, and other issues related to single audits. The document was originally dated September 16, 1998, but will be revised and redated as the DE revises its questions and answers. It was recently revised in December to clarify certain matters with respect to the 1998 Amendment to the Higher Education Act (34 CFR section 668.14(d)(1)).

## Revisions to Government Auditing Standards

### *Are there any recent or upcoming revisions to GAS?*

.49 The Advisory Council on Government Auditing Standards decided last year that it will recommend topic-specific revisions to the GAO on an as-needed basis. Therefore, instead of completely reprinting *Government Auditing Standards* when a change is made, only the new or revised standard will be issued. Periodically, when a significant number of changes have been made, the GAO will reprint a new codification of its standards.

.50 Two exposure drafts were issued by GAO in the last year that would result in changes to the Yellow Book affecting not-for-profit organization financial audits. At the time this Audit Risk Alert was being written, one had been issued as an amendment to the Yellow Book, and one is expected to be issued in the fall of 1999, as discussed in the following sections.

### *Amendment on EDP Controls Issued in 1999*

.51 On May 13, 1999, the first amendment to the 1994 version of *Government Auditing Standards* was issued. The new standard, entitled *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems (GAO/A-GAGAS-1)*, establishes a new field work standard requiring documentation in the planning of financial statement audits in certain circumstances. Specifically, the new standard requires auditors to document in the working papers the basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent on computerized information systems. The new standard also requires auditors to document their consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level. In addition, the standard revises the section titled "Internal Control," in chapter 4 of the 1994 Yellow Book.

.52 SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55*, requires auditors to document their basis for conclusions when control risk is assessed below maximum. However, SAS No. 78 does not impose a similar requirement for assessments of control risk at maximum. The new standard will impose such a requirement for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent on computerized information systems.

.53 The standard also incorporates, where applicable, conforming changes to recognize the effect of SAS No. 78 on generally accepted government auditing standards for internal control. These changes principally consist of updating terminology to conform with SAS No. 78 and deleting guidance that is addressed in SAS No. 78, which was issued after the 1994 version of *Government Auditing Standards*.

.54 The standard is effective for financial statement audits of periods ending on or after September 30, 1999.

.55 An electronic version of the standard can be accessed through the GAO's Internet home page, <http://www.gao.gov>, from the GAO Policy and Guidance Materials or the Special Publications sections of the GAO site, or directly at <http://www.gao.gov/govaud/ybk01.htm>. Printed copies of the standard can be obtained from the Superintendent of Documents at the U.S. Government Printing Office (GPO) by calling (202) 512-1800 or accessing the GPO Web site.

#### **Auditor Communication Exposure Draft**

.56 This exposure draft, *Auditor Communication*, was issued in July 1998. A final standard is expected in the fall of 1999. Once issued, it will likely add a field work standard and amend an existing reporting standard to improve auditor communications with the auditee and users of the reports. Specifically, the new standard is expected to require specific communication with the auditee, individuals contracting for or requesting the auditors services, and the audit committee regarding the scope of compliance and internal control work to be performed. The new standard is also expected to require the auditor to emphasize in the auditor's report on the financial statements the importance of the reports on compliance with laws and regulations and internal control over financial reporting when these reports are issued separately from the report on the financial statements.

.57 Other topics on the council's agenda for the next year include auditor independence and performance auditing. Exposure drafts could possibly be issued in these areas. Watch future issues of the *Journal of Accountancy* and the *CPA Letter* for status updates.

#### **Religious Liberty and Charitable Donation Protection Act of 1998**

##### *How does the Religious Liberty and Charitable Donation Protection Act of 1998 affect not-for-profit organizations and their auditors?*

.58 The Religious Liberty and Charitable Donation Protection Act of 1998 (Public Law 105-183) offers some protection to charitable organizations that receive contributions from bankrupt or soon-to-be bankrupt individuals. As a result of the new law, the organization may be able to keep donations made by such individuals in cases in which the not-for-profit organization previously would have had to return the assets to the bankrupt estate. Assuming the transfers were not made for fraudulent reasons, charitable contributions are allowed for up to 15 percent of the individual's income in the year before bankruptcy filing. Donors can continue to make contributions after filing for bankruptcy. If clients receive contributions from donors who have filed or are soon to file bankruptcy, they may need to assess their ability to retain these contributions or their ability to collect receivables. Some of these assessments may be affected by the Religious Liberty and Charitable Donation Protection Act of 1998.

#### **State and Local Issues**

.59 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 organization registration or licensing requirements; annual reporting requirements; charitable solicitation, registration, and disclosure requirements; charitable gift annuity registrations; and limitations on fund-raising expenses. Some states are actively limiting expenditures of the amounts raised within the state for disaster relief so they are used only for the purposes for which the contributions were raised. 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. Organizations soliciting contributions or selling products on the Internet may be deemed to be doing business in the states from which the sales are initiated, creating a nexus to those states and, perhaps, the responsibility to collect and remit state sales taxes as well as other filing responsibilities.

.60 The American Association of Fund-Raising Counsel, Inc. (AAFRC) publishes its *Annual Survey of State Laws Regulating Charitable Solicitations* (available for \$35). Copies of this publication can be obtained by writing to the AAFRC, Suite 820, at 25 West 43<sup>rd</sup> Street, New York, NY 10036, or by calling (212) 354-5799.

### ***Uniform Registration Form for Fund-Raising and Compliance With Mailing Requirements***

.61 Not-for-profit organizations are required to register and file with the appropriate authorities in most states in which they either have a physical presence or solicit contributions. As a result of a project started by the National Association of State Charity Officials, in conjunction with the National Association of Attorneys General and a consortium of not-for-profit groups, thirty-one states to date have adopted a uniform registration statement, with a view toward easing the administrative burden on organizations that are required to register in more than one state. A copy of the unified registration statement can be found on the Internet Nonprofit Center Web site at [www.nonprofits.org/library/gov/urs](http://www.nonprofits.org/library/gov/urs).

.62 Most states have statutes that include compliance requirements for certain mailings, such as charitable solicitations and sweepstakes. Some states have increased efforts to enforce those statutes. (Also, organizations may be required to withhold taxes on and file information about sweepstakes prizes under IRS requirements.) Auditors should be aware of the existence of such filing requirements and statutes and their potential impact on not-for-profit organizations and their financial statements.

.63 Adverse publicity resulting from an organization's failure to comply with each state's registration and mailing requirements could adversely affect the amounts some donors are willing to contribute. Also, though it is unlikely, such noncompliance could be an illegal act that may have a direct and material effect on the determination of financial statement amounts. SAS No. 54 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 if a possible illegal act is detected.

### ***State Regulations Regarding Registered Fund-Raisers***

.64 In a number of states, there is increased activity to regulate fund-raising consultants. For example—

- Minnesota sued a fund-raiser and the not-for-profit organization for sending out deceptive and misleading appeals to raise funds for local cancer prevention, detection, and education programs that never occurred. The settlements in this case resulted in fines and various conditions being imposed on the not-for-profit organization and the fund-raiser, including that the fund-raiser investigate its clients to ensure they have genuine educational programs and independent and functioning boards.
- In California, a new law has been enacted that expands the definition of a commercial fund-raiser and requires registration, an annual registration fee, and disclosure by certain out-of-state fund-raising consultants, including those who provide only advice on how to fund-raise.
- In Utah, a federal district court has upheld a state law requiring registration, the payment of a registration fee, and maintenance of a bond or letter of credit by out-of-state fund-raising consultants, including those not involved in soliciting. An appeal has recently been filed.
- In Florida, a federal judge granted a summary judgment in favor of Pinellas County, Florida (the County). In that case, a professional fund-raiser from another state objected to the requirement to register with the County before soliciting charitable donations within the County.

Auditors should be aware of the effects of such acts on their clients, including the possibility that there has been an illegal act that may have a direct and material effect on the determination of financial statement amounts.

### ***Full Disclosure in Charity Promotions***

.65 Some not-for-profit organizations enter into marketing arrangements with commercial enterprises in which the not-for-profit organization receives money when the commercial entity sells its products. For example, a potential customer may be told that for each long-distance phone call made through a particular long-distance phone company, the company will make a contribution to one of a group of not-for-profit

organizations. However, in many of these arrangements, the customer is given insufficient information about the benefits to the not-for-profit organizations to make an informed decision about purchasing the product. A number of state laws require explicit disclosure regarding the percentage paid to the not-for-profit organization, and some require the promotion to state the total dollar amount that the not-for-profit organization expects to receive. However, many corporations and not-for-profit organizations fail to provide the required information and include only a vague description of the benefit to the not-for-profit organizations, such as “a portion of the profits.” Although these violations have not been enforced much in the past, the possibility exists that states will be more active in enforcing their rules and applying the penalties. This would mean a concern for the auditor and client about both adverse publicity and the effects on the financial statement amounts resulting from an illegal act, pursuant to SAS No. 54.

## IRS Activities

*What are some of the current tax issues that may affect audits of not-for-profit organizations?*

.66 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 a direct and material effect on the determination of financial statement amounts. SAS No. 54 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. Also, auditors are reminded that not-for-profit organizations are required to apply Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (FASB, *Current Text*, vol. 1, sec. I27), in accounting for income taxes that result from the organization’s activities.

### *Charitable Split-Dollar Life Insurance*

.67 The IRS has been reviewing the use of a controversial method of making contributions to not-for-profit organizations—charitable split-dollar life insurance arrangements. In one common variation of this arrangement, the donor seeks to minimize federal income and estate taxes by making an annual contribution to the not-for-profit, which in turn uses the money, or most of the money, to pay all or most of the premium on a policy insuring the donor’s life. Along with the donation, the donor provides the not-for-profit with a letter stating the not-for-profit organization can use the donated funds any way it wishes, and the donor takes a tax deduction. The policy is held by a separate life insurance trust, the beneficiaries of which are the donor’s heirs. Upon the donor’s death, a portion of the death benefit is paid to the not-for-profit. However, the heirs may receive the bulk of the policy proceeds in addition to the cash value.

.68 In addition to the IRS looking at these arrangements, members of the House Ways and Means Committee have introduced legislation (HR 630 and HR 572, which are available on the Library of Congress Web site at <http://thomas.loc.gov>) that would restrict the use of these arrangements, through such means as imposing a financial penalty on not-for-profit organizations participating in these plans.

.69 Among the possible concerns regarding the use of charitable split-dollar life insurance are—

- The donor may be receiving an improper financial benefit in exchange for the contribution.
- A not-for-profit organization may be providing acknowledgements to the donor that do not accurately reflect the benefit to the donor.
- The arrangement may represent an abuse of the charitable contribution deduction.
- The not-for-profit organization may be providing an accommodation to the donor and getting relatively little benefit from the transaction.

Regulation in this area could have a significant impact on clients that have entered into charitable split-dollar life insurance arrangements. Auditors should continue to monitor events in this area.

### ***IRS Focus on Joint Ventures***

.70 Increasingly, tax-exempt hospitals have joined forces with for-profit entities to enlarge the resource base available with which to provide quality, low-cost health care to the public. In connection with joint ventures of this type, concerns arise about whether a hospital could jeopardize its tax-exempt status or be subjected to the unrelated business income tax.

.71 The IRS has indicated that its Coordinated Examination Program (CEP), which involves audits of such large, complex exempt organizations as not-for-profit hospitals, will focus more on such joint ventures between tax-exempt organizations and taxable entities. CEP audits will be a major component of the IRS Exempt Organizations Division's work plan for this fiscal year and likely for the next fiscal year as well.

.72 This is a follow-up to the IRS's release of Revenue Ruling 98-15, in which two situations involving whole hospital joint ventures between tax-exempt hospitals and taxable entities are discussed. According to the ruling, an Internal Revenue Code (IRC) section 501(c)(3) organization may form and participate in a partnership arrangement if—

1. Such participation furthers a charitable purpose.
2. The partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners.

The ruling's central message appears to be that the analysis is one of facts and circumstances; the fundamental issue is whether the exempt participant has sufficient control to ensure that the venture will be operated in an exempt manner and to prevent private inurement or impermissible private benefit.

### ***Intermediate Sanctions***

.73 IRC section 4958 provides for the imposition of an excise tax of 25 percent of an excess benefit given to a disqualified person. The tax is imposed on the disqualified person and not the organization. Organization managers who knowingly participate in an excess-benefit transaction are subject to an excise tax of 10 percent. Further, an additional excise tax may be imposed on a disqualified person who does not make the organization whole by undoing the excess-benefit transaction.

.74 In July 1998, the IRS issued proposed regulations 53.4958, which define disqualified persons and excess benefit transactions, as well as set forth rules regarding reliance on the advice of council.

.75 The AICPA has issued comments to the IRS suggesting clarifications and other changes to make the regulations less subjective. The AICPA's comments on the proposed rules on intermediate sanctions can be found on the AICPA Web site at [www.aicpa.org/letters](http://www.aicpa.org/letters).

### ***Reversal of United Cancer Council Decision***

.76 The U.S. Court of Appeals for the Seventh Circuit, in *United Cancer Council, Inc. v. Commissioner of Internal Revenue*, reversed and remanded to the Tax Court the decision in a case involving the use of a professional fund-raiser by the United Cancer Council (UCC). (An appeal to the Supreme Court is possible.)

.77 The UCC had hired a fund-raiser that raised \$28.8 million in donations, but only \$2.3 million went to the UCC; the rest went to the fund-raiser. Although the IRS conceded that the contract between the not-for-profit organization and the fund-raiser was negotiated at an arm's-length basis, the IRS contended



that the contract was so advantageous to the fund-raiser and so disadvantageous to the UCC that the not-for-profit organization must be deemed to have surrendered the control of its operations and earnings to the fund-raiser. In 1997, the Tax Court upheld the IRS's revocation. The Tax Court found, despite the fund-raiser being a third party, it had risen to the level of "insider" as a result of the terms of the contract, and that under the contract, the compensation to the fund-raiser was excessive, resulting in inurement.

.78 In February 1999, the Seventh Circuit reversed the decision of the Tax Court and remanded the case to be considered on another issue not resolved by the Tax Court. In reversing the decision, the Seventh Circuit stated that it found nothing in the contract to support the IRS's theory and the Tax Court's finding that the fund-raiser seized control of the UCC and by doing so became an insider, triggering the inurement provision and destroying the exemption.

.79 Auditors should be aware of this issue and the potential for poorly drafted contracts to result in private inurement and a loss of tax-exempt status. To help avoid private inurement issues, contracts should be drafted so the third party cannot be deemed to exercise control of the not-for-profit organization.

### *Travel Tours*

.80 The IRS has placed additional emphasis on travel tours conducted by exempt organizations. Specifically, the issue is whether the recreational and social aspects of the tour outweigh the educational aspects. Many in the commercial travel industry believe that tax-exempt organizations are competing unfairly in the travel tour business.

.81 The IRS has issued proposed regulations 1.513-7, giving four examples illustrating which tour activities might be exempt and which might give rise to unrelated business taxable income (UBTI). The IRS' determination of whether a tour gives rise to UBTI appears to involve—

- Scheduled instruction.
- Established curriculum.
- Required minimum time commitment for organized study.
- Report preparation.
- Lectures by instructors.
- Mandated examinations.
- Availability of academic credit.

These factors should be considered whether the exempt organization operates the tour directly or merely receives a fee from a travel agency for each member who signs up.

.82 The AICPA's comments on the proposed rules on exempt organization travel and tour activities can be found on the AICPA Web site at [www.aicpa.org/letters/touregs2.htm](http://www.aicpa.org/letters/touregs2.htm).

### *College Golf Courses*

.83 In a letter ruling (TAM 9645004), the IRS ruled that golf course fees from alumni, spouses, donors, and guests were UBTI. The IRS said that such people were part of the general public and that their use of facilities did not accomplish any exempt educational purpose. Colleges, universities, or other large tax-exempt institutions should analyze revenue from such sources as golf courses, computer centers, athletic facilities, auditoriums, or bookstores for possible UBTI arising from alumni, spouses, donors, and guests.

### *Penalties for the Abuse of Tax Shelters Apply to Not-for-Profit Organizations*

.84 According to the IRS' 1999 *Exempt Organizations Continuing Professional Education Technical Instruction Program* (published by the IRS Exempt Organization division for its employees), charities and certain individuals that use misleading or deceptive fund-raising techniques can face penalties for promoting abusive tax shelters (IRC section 6700) and aiding and abetting tax understatement (IRC section 6701). Among the examples in the manual is one in which the organization solicits used vehicles and provides misleading or false valuations for donated vehicles in acknowledgments to donors.

.85 The material in the Technical Instruction Program is designed specifically for training purposes only and is not to be used or cited as authority for setting or sustaining a technical position. It is available on the IRS Web site at [http://www.irs.ustreas.gov/prod/bus\\_info/eo](http://www.irs.ustreas.gov/prod/bus_info/eo).

### *IRS Regulations on Disclosure*

.86 Final regulations were released April 9, 1999, relating to tax-exempt organization disclosure requirements under IRC section 6104(e), which require exempt organizations to provide copies of their exemption applications and three most recent information returns upon request. The new public disclosure rules, which take effect on June 8, 1999, provide that—

1. Requests made in person generally must be responded to immediately.
2. Written requests must be responded to within thirty days.

.87 Reasonable fees to cover administrative costs for postage and reproduction are permissible. Exceptions to this rule are provided if—

1. The documents are requested to harass an organization; however, the IRS has indicated that harassment campaigns probably will be "narrowly construed."
2. The documents are made "widely available" (that is, making materials available via electronic means, such as the Internet).

Failure to comply with the public inspection rules could result in a \$20-per-day penalty (subject to a \$10,000 maximum), with a \$5,000 penalty for willful failure.

.88 The Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998 extends the new disclosure rules to private foundations. However, until regulations are issued covering disclosures by private foundations, the existing private foundations disclosure rules will remain in effect. The IRS is expected to issue proposed regulations relating to disclosure requirements for private foundations during 1999.

### *Contributing Stock to a Private Foundation*

.89 Through June 30, 1998, a donation of "qualifying appreciated stock" to a private foundation was deductible by the donor at fair market value (rather than the donor's basis). The gift must have been publicly traded stock that would have produced long-term capital gains if sold and no more than 10 percent of the corporation's stock could be given to the foundation by the donor and the donor's family (including prior contributions). Although this provision (IRC section 170(e)(5), as amended) had expired on June 30, 1998, it has been made permanent and retroactive to all contributions of qualified appreciated stock made on or after July 1, 1998, by the Omnibus Consolidated and Emergency Supplemental Appropriations Act of 1998 (Public Law 105-277).

### *Transfers of Assets to Exempt Entities*

.90 The IRS has issued final regulations under IRC section 337(d). These regulations discuss the tax treatment for situations when a taxable corporation transfers all or substantially all its assets to a tax-exempt

entity and when a taxable corporation changes its status to a tax-exempt entity. Other matters covered include the effect of use by the tax-exempt entity of the assets in an activity that produces UBTI. The regulations were published in the December 29, 1998, *Federal Register*.

### *Donor-Advised Funds*

.91 Recent news articles have noted that Congress and the IRS are concerned about whether commercially sponsored donor-advised funds are subject to sufficient oversight. These funds, like community foundations, allow donors to make contributions to funds maintained by a not-for-profit organization, claim a charitable deduction, and then recommend whether and to whom the funds should be distributed. One concern is that these funds, unlike private foundations, are not required to distribute any minimum amount of assets. Another concern is that donors may be allowed to maintain too much control. Among the possible solutions mentioned is the creation of a new category of not-for-profit organization to include organizations such as commercially sponsored donor-advised funds and traditional community foundations, with their own set of rules, including minimum distribution rules similar to those governing private foundations. In addition to monitoring legislative and regulatory events in this area, readers can refer to an article in the 1999 *Exempt Organizations Continuing Professional Education Technical Instruction Program*.

## **Audit and Attestation Issues and Developments**

### **Restricted-Use Reports**

*What new guidance has been issued with respect to restricted-use reports and how will this affect audits of not-for-profit organizations?*

.92 SAS No. 87, *Restricting the Use of an Auditor's Report*, was issued in September 1998 by the Accounting Standards Board (ASB) and is effective for reports issued after December 31, 1998.

.93 Two restricted-use reports commonly issued by auditors of not-for-profit organizations will be affected by SAS No. 87:

1. Report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with GAS
2. Report on compliance with requirements applicable to each major program and internal control over compliance in accordance with OMB Circular A-133

.94 SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The SAS states that an auditor should restrict the use of a report if the following occurs.

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or an other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

.95 In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language

to be used in restricted-use reports, and requires an auditor to restrict a single combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. SAS No. 87 permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

.96 The SAS provides that an auditor's report that is restricted as to use should contain a separate paragraph at the end of the report that includes the following elements:

1. A statement indicating that the report is intended solely for the information and use of the specified parties
2. An identification of the specified parties to whom use is restricted
3. A statement that the report is not intended to be and should not be used by anyone other than the specified parties

.97 An example of such a paragraph is the following:

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

The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report. The SAS provides that for reports on engagements performed in accordance with the OMB Circular A-133, the specified parties may be identified as "federal awarding agencies and pass-through entities."

.98 Among the conforming changes needed as a result of this SAS is that the sentence "However, this report is a matter of public record and its distribution is not limited" in paragraph 47 of SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 1, AU sec. 622), and in footnote 7 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), will be deleted, and should no longer be added to auditor's reports. As a result, certain reports included in AICPA SOP 98-3 will change.

.99 To help CPAs update their restricted-use reports, SAS No. 87 contains an appendix identifying affected restricted-use reports in the SASs and in the AICPA Audit and Accounting Guides.

## 1999 Audit and Accounting Guide Revisions

.100 The following list shows some of the revisions that will be included in the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* with conforming changes as of May 1, 1999. The revisions made include those to reflect the issuance of the following:

- SAS No. 87
- Statement on Standards for Attestation Engagements (SSAE) No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3* (amending SSAE Nos. 1 [AICPA, *Professional Standards*, vol. 1, AT sec. 100]; 2 [AICPA, *Professional Standards*, vol. 1, AT sec. 400]; and 3 [AICPA, *Professional Standards*, vol. 1, AT sec. 500])
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50)

.101 Additionally, as a result of the following SOPs, sections were added to discuss the issues covered by them:

- SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- 98-5, *Reporting the Costs of Start-Up Activities*

## Analytical Procedures

*What are some of the areas of concern when applying analytical procedures in audits of not-for-profit organizations?*

.102 Analytical procedures are required to be used in the planning and overall review stages of the audit according to SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329). In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives. Auditors should be aware of the need to have analytical procedures performed by staff with sufficient industry expertise to properly evaluate the results, particularly when analytical procedures are being performed in lieu of other substantive auditing procedures.

.103 In performing analytical procedures, the auditor compares amounts or ratios with expected results developed from such sources as the following:

- Prior-period financial information
- Budgets or forecasts
- Relationships among elements of financial information in the same period
- Relationships among financial and nonfinancial data
- Industry data compiled by services

.104 Some of the more significant financial ratios for a not-for-profit organization are the following:

- Net assets by class
- Current ratio
- Receivables to revenues (by activity)
- Program expenses to total expenses
- Fund-raising expenses to contribution revenue
- Fund-raising expenses to total expenses
- Personnel expenses to total expenses

Other types of analytical procedures often used in a not-for-profit organization environment involve revenue-producing activities and the costs associated with revenue-producing activities.

.105 Two factors may increase the usefulness of certain comparisons that can be used by the auditor when performing analytical procedures in an audit of a not-for-profit organization. First, as the accounting for not-for-profit organizations has become more uniform as a result of recent accounting pronouncements (such as FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made* [FASB, *Current Text*, vol. 2, sec. No5]; FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations* [FASB, *Current Text*, vol. 2, sec. No5]; and SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*), comparability may be improved among organizations, and thus increase the effectiveness of analytical procedures involving comparisons with compiled “industry” data. Additionally, the increase in information on the Internet may provide additional sources of information for auditors seeking data for use in these analytical procedures, though industry statistics may still be difficult to obtain. Appropriate industry statistics may be available from various member groups (for example, groups for private schools or cultural institutions) or from organizations, such as the American Society of Association Executives, some of which are listed in the appendix to this Alert.

.106 Despite improved comparability brought about by changes in accounting standards and more readily available data, auditors may still face some difficulties when attempting to compare client-generated information with industry statistics. Information on not-for-profit organizations may be difficult to compare because not-for-profit organizations (1) operate in such a wide variety of areas, including social service organizations, museums, membership associations, performing arts organizations, foundations, colleges, and others; (2) exist in a wide variety of sizes; and (3) have other differences. Those differences result in a diversity in industry statistics pertaining to financial information for not-for-profit organizations. For example, in the area of program-expense-to-overall-expense ratios, a smaller not-for-profit may have higher levels of management and general expenses than a larger organization. Also, even organizations of similar size can vary widely with respect to program-expense-to-overall-expense ratios. Many factors can affect the amount of nonprogram expense, such as the organization's structure and the nature of the services performed. In some cases, comparisons with budget and prior year may be more relevant than comparisons with other organizations.

.107 The AICPA has developed a new Auditing Practice Release, *Analytical Procedures* (Product No. 021069), to provide guidance on the effective use of analytical procedures, with emphasis on analytical procedures as substantive tests. It includes a discussion of SAS No. 56, the underlying concepts and definition, a series of questions and answers, and an illustrative case study.

## Consideration of Fraud in a Financial Statement Audit

*What types of issues should auditors of not-for-profit organizations be aware of with respect to client fraud?*

.108 Increasingly, the financial affairs of not-for-profit organizations are subject to scrutiny by different groups. Not-for-profit organizations are facing increasing pressure to meet certain expectations with respect to "watch dog" groups that monitor how different organizations use their resources. Also, there has been an increase in the availability of their Form 990s (including posting on the Internet) to donors, regulators, journalists, and others. Because the image of the not-for-profit organization has such a significant impact on a donor's willingness to contribute, negative financial press can significantly decrease future contributions. As a result, the not-for-profit organization may feel pressure to report certain financial results at certain levels even though they result in a material misstatement.

.109 In addition to aforementioned pressures, additional factors that not-for-profit organizations face include the use of significant numbers of volunteer workers who may not be properly trained or supervised, pressure to keep down managerial expenses resulting in inadequate internal control, numerous locations at which contributions are collected, boards of directors who believe that those involved with the charity would not act in a deceptive manner, inexperienced accounting staff, and reliance on board members to help in obtaining needed goods and services, resulting in related-party transactions. Auditors may need to consider such issues as part of their assessment of the risk of material misstatement due to fraud, as required by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

.110 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 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." SAS No. 82 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS. Specifically, SAS No. 82—

- Describes fraud and its characteristics.
- Requires the auditor to specifically assess the risk of material misstatement due to fraud and provides categories of fraud risk factors to be considered in the auditor's assessment.

- Provides guidance on how the auditor responds to the results of the assessment.
- Provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud.
- Describes related documentation requirements.
- Provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others.

.111 The following are a few of the many risk factors discussed in SAS No. 82 that may exist in a particular not-for-profit organization audit client:

- 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
- Inadequate monitoring of significant controls
- High turnover of senior management, counsel, or board members
- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity
- Large amounts of cash on hand or processed
- Lack of appropriate management oversight (for example, inadequate supervision or monitoring or remote locations)
- Lack of appropriate segregation of duties or independent checks

.112 Among its provisions, SAS No. 82 provides guidance on how the auditor responds to the results of the risk assessment. Specific responses to the results of the assessment might include the assignment of more senior or experienced personnel to plan and perform certain auditing procedures, increased sensitivity in the selection of the nature and extent of documentation to be examined, and increased recognition of the need to corroborate management explanations or representations concerning material matters. Additional guidance on the response to the presence of fraud risk factors is contained in SAS No. 82 and in the AICPA publication *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883). Auditors may also be interested in the continuing professional education courses *Applying Fraud SAS No. 82 in Government and Not-for-Profit Organizations* (Product No. 735130) and *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities Under SAS No. 82* (Product No. 732046, text version, or Product No. 738080, CD-ROM version).

## Acts of Volunteers

*What are some of the issues auditors should be aware of with respect to the use of volunteers and the application of the Volunteer Protection Act of 1997?*

.113 A recent case in Washington State highlights that not-for-profit organizations should not rely on the Volunteer Protection Act of 1997 to shield the organization from liability for the negligent acts of its volunteers. This law provides some liability protection to individual volunteers, rather than to the organization. In *Jason Scott v. Ross et al.*, the U.S. Court of Appeals of the Ninth Circuit upheld a verdict that a not-for-profit organization, Cult Awareness Network (CAN), was liable for the negligent acts of one of its volunteers. Because many not-for-profit organizations use volunteers, auditors should be aware that there is a possibility that the actions of a volunteer could result in a liability for the client.

.114 Signed into law in 1997, the Volunteer Protection Act (the Act) protects volunteers from liability for negligent acts or omissions while acting within the scope of their responsibilities. It does not protect volunteers

from liability for gross negligence or willful or criminal misconduct. It also does not protect the not-for-profit organization to which the volunteer provides the service. The Act, coupled with an already increasing stream of volunteers, places more emphasis on the need for not-for-profit organizations to train and supervise volunteers properly for both operational and financial reasons. Auditors should consider whether not-for-profit organizations have adequate internal control relating to the proper training and supervision of volunteers to minimize the organization's potential exposure to liabilities from the actions of volunteers.

.115 A weakness in this regard might suggest an increased risk of a condition, situation, or set of circumstances indicating an uncertainty about the possible loss to an entity arising from litigation, claims, and assessments, pursuant to SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).

.116 It is also possible that a volunteer can be involved in an illegal act, as discussed in SAS No. 54. The term *illegal acts* as used in that SAS refers to violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity.

.117 In addition to other matters, the SAS explains that the auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in footnote 1 in SAS No. 1.

## Exchange Transactions

### *Why are exchange transactions of increasing importance to not-for-profit organizations and their auditors?*

.118 Some not-for-profit organizations receive significant revenues from exchange transactions, such as some or all of dues, service fees, and ticket sales. According to one report, from 1977 through 1996, more than half the growth in revenue for not-for-profit organizations was due to fees and other earned income. In addition to the increased volume, organizations also are entering into new kinds of exchange transactions. For example, with the increase in the number of for-profit organizations bidding on government social service contracts, some organizations are entering into joint ventures with for-profit entities, or providing the service as a subcontractor to a for-profit entity that is doing the outsourcing for the government. Often, significant judgment is needed to determine whether a transaction is a contribution, an exchange transaction, or part contribution and part exchange transaction. The auditor needs to have a thorough understanding of the substance of the underlying transaction to audit management's assertions about those determinations.

.119 Exchange transactions are reciprocal transfers in which each party receives and sacrifices something of approximately equal value. Exchange transactions that give rise to revenues for not-for-profit organizations typically involve their efforts to provide goods and services to members, clients, students, customers, and other beneficiaries for a fee. Areas of difficulty when evaluating whether a reciprocal transaction has occurred include the following:

- Membership dues that are part contribution and part exchange transaction, because the member receives tangible or intangible benefits in return for membership dues (The AICPA Audit and Accounting Guide *Not-for-Profit Organizations* [the Guide] provides a list of indicators that may be useful for determining the contribution and exchange portions of membership dues.)
- Transfers from governments, such as grants, awards, and appropriations in which the unique characteristics make it difficult to determine whether they are contributions or exchange transactions

The Guide provides a list of indicators that may be useful in distinguishing between contributions and exchange transactions. Among the important indicators are: the not-for-profit organization's intent, the



resource provider's expressed intent, the method of delivery, the method of payment, the imposition of penalties if the not-for-profit organization fails to make timely delivery, and the person or entity to whom the not-for-profit organization delivers the assets.

.120 In addition to identifying exchange transactions, as not-for-profit organizations enter into more and varied transactions to earn revenue, the auditor may need to consider how these transactions will affect the audit. For example:

- Auditors need to understand the client's methods of soliciting contributions and earning revenues as part of the planning process, as discussed in SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). SAS No. 22 requires, in part, that in planning the audit, the auditor should consider matters relating to the entity's business and the industry in which the entity operates.
- As new activities are employed to increase revenues, the client may not have developed appropriate internal control. Auditors should consider the impact of such changes on their client's internal control when making the assessment of control risk. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS. Also, the AICPA Audit and Accounting Guide *Consideration of Internal Control in a Financial Statement Audit* (Product No. 012451) has been prepared to illustrate how SAS No. 55, as amended, might be applied by auditors in audits of financial statements.
- Accounts receivable resulting from exchange transactions may be need to be confirmed, as required by SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330).
- Analytical procedures, as discussed in SAS No. 56, are often very effective and efficient when auditing service fees and other types of revenue from exchange transactions.
- Transactions occurring near year end should be examined to ensure that they are recorded in the period in which the revenue has been earned or the expense has been incurred, pursuant to the completeness assertion of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326).
- Some not-for-profit organizations provide services to the general public and receive reimbursement from a third party (such as Medicare). Usually, a contract specifies the costs that can be charged and the basis for reimbursement. Clients need to understand the relevant contract terms to properly process transactions within the guidelines of the contract.
- Amounts received in exchange transactions from customers, patients, and other service beneficiaries for specific projects, programs, or activities that have not yet taken place should be recognized as liabilities to the extent the earning process has not been completed.
- At some not-for-profit organizations, accounting personnel may not be as familiar with revenue recognition concepts related to sales of goods and services as they are with revenue related to contributions. A number of issues can arise when dealing with the question of revenue recognition, such as the timing of when revenue has been earned. For example, FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (FASB, *Current Text*, vol. 1, sec. R75), specifies criteria for recognizing revenue on a sale in which a product may be returned.

## Financial Statements on the Internet

*What issues should the auditor consider when the not-for-profit organization client has posted audited financial statements on the Internet?*

.121 More not-for-profit organizations are making information available on the Internet or electronic bulletin boards (electronic sites). Information in electronic sites may include financial information, press

releases, and other promotional material. Auditors should be aware that Interpretation No. 4, "Other Information in Electronic Sites Containing Audited Financial Statements," of SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1 AU sec. 9550), addresses 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.

.122 The Interpretation 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. Therefore, auditors are not required by SAS No. 8 to consider the consistency of information in electronic sites with the original documents or to read other information in electronic sites. The Interpretation 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. However, other auditing or attestation standards, such as agreed-upon procedures, may apply.

.123 The AICPA has issued a nonauthoritative Practice Alert titled *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 via the AICPA's Fax Hotline at (201) 938-3787, document number 1566, and the AICPA's Web site at [www.aicpa.org/pubs/cpaltr/jan97/suppl/prac.htm](http://www.aicpa.org/pubs/cpaltr/jan97/suppl/prac.htm).

## The Year 2000 Issue

*What is the Year 2000 Issue and how will it affect audits of not-for-profit organizations?*

.124 The Year 2000 Issue relates to the inability of many electronic data processing (EDP) systems to accurately process year-date data beyond the year 1999. This is attributable to the fact that the majority of computer programs in use today were designed to store dates in the date/month/year (dd/mm/yy) format, thus allowing only two digits for each date component. So, for example, the date December 31, 1998, is stored in most computers as 12/31/98. Inherent in programming for dates in this manner is the assumption that the designation 98 refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit-year input fields will cause many computers to treat the entry 00 as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00), as January 1, 1900, and process data incorrectly, or perhaps not at all.

.125 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year 2000 ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur this year. For example, some software programs may have assigned special meanings to entries date coded as xx/xx/98 or xx/xx/99 to allow for the testing of software modifications. Therefore, actual transactions using such dates may be processed incorrectly or the program may stop functioning. Failures may also take place currently when systems perform calculations into or beyond the year 2000.

.126 Unless these year 2000 problems are remedied, significant problems relating to the integrity of all electronically processed information based on time will occur. Among the problems that may be experienced by not-for-profit organizations are that receivables may be erroneously identified as past due, interest calculations may be incorrect, periodic memberships and subscriptions may be deemed to be expired, vital information may be lost (such as donor lists that contain date information and lists of advance ticket sales), credit cards may be rejected, and so on. Also, with the increasing use of the Internet, more not-for-profit organizations are allowing donors to make contributions online using credit cards. These donations may not be properly processed. For some not-for-profit organizations, staff may be keeping data on home computers (or on ad hoc systems developed outside of the main applications) that will be affected by the year 2000 problem. Also, equipment with embedded chips that include date information may malfunction; this type of equipment can be found in such places as elevators, security systems, and other electronic devices. Not

only can these types of problems affect office facilities, but they may also affect facilities where special events have been scheduled. Additionally, the organization's systems may be affected by the computer systems of customers, vendors, or third-party data processing services that have made no such modifications.

.127 Clearly, the Year 2000 Issue has the potential to adversely affect the operations of entities that rely, directly or indirectly, on information technology. What, however, are the auditor's responsibilities for the Year 2000 Issue?

.128 First, it must be understood that it is the responsibility of an entity's management to assess and remediate the effects of the Year 2000 Issue on an entity's systems—not the auditor's. The Year 2000 Issue does not create additional responsibilities for the auditor. Under GAAS, 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Year 2000 Issue or by some other cause.

.129 Not-for-profit organizations may be particularly at risk for year 2000 computer complications because they may not have sufficient resources to remedy the problem. Some of these organizations may be relying on donated services for computer assistance and be reluctant to allocate the resources needed to hire specialists in this area.

.130 A more detailed discussion of the auditing and accounting issues is included in the *Audit Risk Alert—1998/1999* [AAM section 8010]. However, a few of the numerous auditing and accounting considerations that arise out of the Year 2000 Issue are repeated here.

- The Audit Issues Task Force (AITF) of the ASB issued the following Auditing Interpretations:
  - Interpretation No. 4, "Audit Considerations for the Year 2000 Issue," of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311.38)
  - Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19)
  - Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.03)
- Auditors should consider whether the costs associated with their client's modifications of computer systems pursuant to the Year 2000 Issue have been properly accounted for. The Emerging Issues Task Force (EITF) has considered this matter in EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*.
- EITF Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, provides relevant guidance when an entity's year 2000 project involves business process reengineering.
- The Year 2000 Issue may render certain client assets (such as computer hardware and software) obsolete or inoperable. Accordingly, auditors may wish to consider whether the client has properly accounted for such events by appropriately adjusting useful lives, residual values, or both, or recognizing impairment losses pursuant to the guidelines set forth under FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. 108).
- In addition to the disclosure requirements under the pronouncements previously mentioned, practitioners should be aware of the requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Auditors should also be aware of the risk of litigation relating to the Year 2000 Issue. Some clients may be uninformed about the Year 2000 Issue, while others may underestimate its magnitude. Those who mistakenly believe that the Year 2000 Issue should be addressed and resolved as part of the audit process may seek legal recourse if that outcome is not achieved. Therefore, auditors may wish to educate their clients on the Year 2000 Issue and its implications. Auditors may wish to incorporate these issues in the engagement letter by outlining the responsibilities of both the client and the auditor. By advising the client and planning ahead, auditors may avoid any potential dispute with the client, while at the same time offering the opportunity of helping the client understand the seriousness of the problem and identifying resources that may be needed to address the issues.

.131 A more complete discussion of the implications of the Year 2000 Issue, along with a list of published guidance in this area, can be found in the *Audit Risk Alert—1998/99* [AAM section 8010]. Also, the AICPA's Web site, <http://www.aicpa.org>, provides a year 2000 resource page with additional information and links to other sites, and the AICPA publication, *The Year 2000 Issue: Current Accounting and Auditing Guidance*.

## Going-Concern Issues

*What are some of the issues that auditors should consider with respect to the client's ability to continue as a going concern?*

.132 There are many factors that can affect the ability of a not-for-profit organization to continue as a going concern. The first issue that usually comes to mind is the impact of declining contribution revenue. For example, although many not-for-profit organizations have benefited from increases in contributions over the last several years, not all organizations have benefited equally. Another concern is the increasing encroachment of for-profit entities in areas that were previously considered the territory of not-for-profit organizations, such as providing social services under government contracts. Also, not-for-profit organizations can be affected by negative publicity about their organization or other similar organizations. Accordingly, auditors should be alert to conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt about a not-for-profit organization's ability to continue as a going concern. For example, such conditions and events could include the following:

1. Negative trends, such as negative cash flows from operating activities and adverse key financial ratios
2. Financial difficulties, such as the need to seek new sources or methods of financing or to dispose of substantial assets
3. Internal matters, such as substantial dependence on the success of a particular project
4. External matters, such as legal proceedings that could jeopardize the entity's ability to operate

In such circumstances, auditors may conclude that, based on such conditions and events, there is substantial doubt about the not-for-profit organization's ability to continue as a going concern.

.133 Accordingly, 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). SAS No. 59 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.

## Attestation Engagements

*What new guidance should auditors of not-for-profit organizations be aware of with respect to attestation engagements?*

.134 Auditors of not-for-profit organizations may be requested to provide attestation services. Attest services include, for example, reports on descriptions of computer software; on investment performance

statistics; on information supplementary to financial statements; on compliance with statutory, regulatory, and contractual requirements; and on internal control.<sup>7</sup> Examples specific to not-for-profit organization clients include reports on statistics based on management assertions, such as the number of meals served or the number of clients benefited by a particular service of the not-for-profit organization.

.135 In January 1999, the ASB issued SSAE No. 9, which—

- Enables a practitioner to report directly on specified subject matter, such as an entity's internal control over financial reporting, rather than on management's assertion about the internal control. In either case, the practitioner would continue to be required to obtain management's assertion as a condition of engagement performance.
- Eliminates, in certain cases, the requirement for a separate presentation of management's assertion if the assertion is included in the introductory paragraph of the practitioner's report.
- Revises the reporting guidance on the SSAEs so that SSAE reports would contain elements that are similar to those included in auditors' reports on historical financial statements, as prescribed in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508).
- Provides guidance on the relationship between the SSAEs and the Statements on Quality Control Standards.

## Accounting Issues and Developments

### Start-Up Activities

*What new guidance has been issued with respect to start-up activities?*

.136 As not-for-profit organizations are faced with competition from other not-for-profit organizations, as well as from for-profit entities, they may alter their operations to be more competitive, and start up new activities. A recent pronouncement helps not-for-profit organizations and their auditors in addressing the accounting issues surrounding start-up activities.

.137 In April 1998, the Accounting Standards Executive Committee (AcSEC) issued SOP 98-5, *Reporting on the Costs of Start-Up Activities*. This SOP provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred.

.138 The SOP broadly defines start-up activities and provides examples to help entities determine what costs are and are not within the scope of this SOP. This SOP applies to all nongovernmental entities and is generally effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements previously have not been issued. Initial application of this SOP generally should be reported as the cumulative effect of a change in accounting principle, as described in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*. When adopting this SOP, entities are not required to report the pro forma effects of retroactive application.

.139 Illustration 3 provided in SOP 98-5 refers to not-for-profit organizations and provides the following example.

A not-for-profit organization that has provided meals to the homeless is opening a shelter to house the homeless. The organization will rent the facility. This will be the organization's

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<sup>7</sup> This is not the same as the reports on internal control required by the Yellow Book and Circular A-133.

first shelter and it will conduct a fund-raising campaign to raise money to start up the shelter. The organization will lease space for the shelter and will incur capital expenditures for leasehold improvements and furniture. The organization expects that it will require three months to set up the space for the shelter. The organization will hire a security firm to secure the premises during the three-month period in which the shelter is built. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of [SOP 98-5]:

- Employee salary-related costs related to needs and feasibility studies
- Staff recruiting and training
- Rent, security, insurance, and utilities
- Consultant fees for developing policies and procedures for operating the shelter
- Amortization and depreciation, if any, of leasehold improvements and furniture
- Costs of social workers

The following costs incurred in conjunction with start-up activities are outside the scope of [SOP 98-5] (as noted in paragraphs .07 and .08):

- Costs of fund-raising
- Costs of leasehold improvements and furniture
- Architect fees for the leasehold improvements
- Advertising costs to publicize the shelter

**.140** Auditors should review SOP 98-5 and its illustrations to assess whether management has properly accounted for start-up activities pursuant to the provisions of the SOP, and that the applicable guidance in other authoritative literature has been followed for those costs that are outside of the scope of the SOP.

## Joint Activities

*What new guidance has been issued with respect to accounting for joint activities, and what issues have resulted from the new guidance?*

**.141** Auditors are reminded that SOP 98-2 is effective for financial statements for years beginning on or after December 15, 1998. Earlier application is encouraged in fiscal years for which financial statements have not been issued. If comparative financial statements are presented, retroactive application is permitted but not required.

**.142** Additionally, the AITF of the ASB has recently issued the following AITF Advisory on Reporting the Adoption of SOP 98-2:

In March 1998, the Accounting Standards Executive Committee issued SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, which is effective for financial statements for years beginning on or after December 15, 1998. The adoption of the SOP may change amounts reported as program expense, management and general expense, and fundraising expense, but will not change total expenses or changes in net assets. In discussing the import of the classifications covered by the SOP, paragraph C-6 notes that external financial statement users of not-for-profit organization's financial statements focus on and have perceptions about amounts

reported as program, management and general, and fund raising. The Audit Issues Task Force of the Auditing Standards Board is advising auditors that the adoption of the SOP, whether or not retroactively applied, is an accounting change for which the consistency standard is applicable. If the change has a material effect on the comparability of the entity's financial statements, the auditor should refer to the change in an explanatory paragraph of his or her report in accordance with SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.16).

## **New AICPA Technical Practice Aids**

.143 In March 1999, the AICPA staff published additional nonauthoritative guidance regarding not-for-profit organizations in the section titled "Accounting and Auditing Publications Technical Questions and Answers (Nonauthoritative)" in the *AICPA Technical Practice Aids*, section 6140.<sup>8</sup> Also, the additional nonauthoritative guidance can be found on the AICPA Web site at [www.aicpa.org/members/div/acctstd/general/nfptpa.htm](http://www.aicpa.org/members/div/acctstd/general/nfptpa.htm). Shown here is an abridged version of the items added to the technical questions and answers (nonauthoritative) section.

### ***Lapsing of Time Restrictions on Receivables That Are Uncollected at Their Due Date***

.144 Some contribution receivables are uncollected at their due date. Time restrictions on those receivables lapse when the receivable is due, rather than when it is collected.

### ***Lapsing of Restrictions on Receivables If Purpose Restrictions Pertaining to Long-Lived Assets Are Met Before the Receivables Are Due***

.145 Not-for-profit organizations may receive promises to give contributions that are restricted by donors for investment in long-lived assets. In some circumstances, the assets may be placed in service, and the purpose restrictions met, prior to the due date of the contribution. For example, a not-for-profit organization may have a capital campaign, asking for commitments to contribute over the next five years so the organization can build a new facility. A donor may promise to give \$100,000 in five years in response to that request. In considering whether the restrictions are met when the assets are placed in service (purpose restriction) or when the receivable is due (time restriction), not-for-profit organizations should consider the facts and circumstances surrounding the promise to give and whether those facts and circumstances indicate that the donor intended the contribution to be used to support activities of the current period, with constructing the building or placing it in service considered activities of the current period. If circumstances indicate that the donor intended to support activities of the current period, there is no time restriction. If circumstances indicate that the donor's intent is not to support activities of the current period, there are both a time restriction and a purpose restriction. In conformity with footnote 5 of FASB Statement No. 116, the effect of the expiration of restrictions is recognized in the period in which the last remaining restriction has expired.

### ***Not-for-Profit Organization Accounting for Loans of Cash That Are Interest Free or That Have Below-Market Interest Rates***

.146 Some not-for-profit organizations receive loans of cash that are interest free or that have below-market interest rates. Interest expense and contribution revenue should be reported in connection with those loans (regardless of whether the loan is between related parties). Those contributions should be measured at fair value, which is the difference between the fair value of the loan at market rates and the fair value of the loan at its stated rate. The corresponding entry would be to interest income for the donor and to interest expense for the donee.

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<sup>8</sup> This material has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA. These answers are not sources of established accounting principles as described in SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, nor are they sources of authoritative GAAS.

### ***Functional Category of Cost of Sales of Contributed Inventory***

.147 Some not-for-profit organizations receive contributions of inventory that they subsequently sell. Cost of sales of contributed inventory should be reported as the cost of a separate supporting service, unless the item sold is related to a program activity, in which case, cost of sales is reported as a cost of a program activity. Cost of sales of contributed inventory should not be reported as fund-raising.

### ***Functional Category of Costs of Special Events***

.148 Various sections of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* discuss special fund-raising events. The discussion of special fund-raising events in the Guide provides that some, but not necessarily all, costs of special fund-raising events should be reported as fund-raising. Certain costs of special fund-raising events, such as costs of direct donor benefits that are provided in exchange transactions, should be reported in categories other than fund-raising.

### ***Functional Category of the Costs of Direct Donor Benefits***

.149 Some not-for-profit organizations provide direct donor benefits. The costs of direct donor benefits that are not program related and that are provided in exchange transactions, such as benefits provided at special events, should be reported as a separate supporting category, such as cost of sales, and should not be reported as fund-raising.

### ***Reporting Bad-Debt Losses***

.150 Under footnote 27 to paragraph 5.56 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, certain bad debts arising from unconditional promises to give should be accounted for as losses, rather than as expenses. Bad-debt losses are prohibited from being netted against contribution revenue under paragraph 25 of FASB Statement No. 117 because losses are permitted to be netted only against gains, and not against revenues.

### ***Political Action Committees***

.151 Some not-for-profit organizations are related to other not-for-profit organizations that perform political activities that the reporting organization does not wish to perform, perhaps because performing those activities may threaten the reporting organization's tax exempt status, the reporting organization is precluded from conducting such activities, or for other reasons. SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, requires consolidation of political action committees in certain circumstances.

## **Reporting of Related Entities**

### ***What new developments have occurred with respect to accounting for related entities of not-for-profit organization clients?***

.152 An ongoing issue for not-for-profit organizations involves accounting for related entities. This is not only an accounting issue, but also an issue of public attention. Some organizations have had negative publicity arising from situations in which the organization has a for-profit arm that is portrayed as being subsidized by the tax benefits available to the not-for-profit organization.

.153 Current accounting guidance with respect to related entities includes, among other pronouncements, FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. 1, sec. R36) and SOP 94-3. However, additional guidance in this area is expected as a result of the FASB's consolidations project. If the FASB proposed Statement resulting from its consolidations project 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 (a discussion on which follows).



.154 In February 1999, the FASB issued an exposure draft, *Consolidated Financial Statements: Purpose and Policy (Revision of Exposure Draft issued October 16, 1995)*. The proposed Statement would establish standards that specify when entities should be included in consolidated financial statements. It would apply to business enterprises and not-for-profit organizations that control other entities regardless of the legal form of the controlling and controlled entities. The proposed Statement would not apply to financial statements of certain reporting entities, such as pension plans and investment companies, that in accordance with GAAP carry substantially all of their assets, including investments in controlled entities, at fair value with all changes in value reported in a statement of net income or financial performance.

.155 The proposed Statement would require that a controlling entity (parent) consolidate all entities that it controls (subsidiaries) unless control is temporary at the time the entity becomes a subsidiary. For purposes of that requirement, control of an entity is a non-shared decision-making ability of an entity so as to increase its benefits and limit its losses from that other entity's activities.

.156 The proposed Statement would preclude consolidation of a new subsidiary if a parent's control is temporary at the date that control is obtained. Control of a newly acquired subsidiary would be considered temporary if at the date of acquisition the parent either has committed to a plan to relinquish control of that subsidiary or is obligated to do so and it is likely that loss of control will occur within one year. However, control also would be considered temporary if at the date of acquisition circumstances beyond management's control are likely to require more than one year to complete the ultimate disposition.

.157 The proposed Statement would supersede the provisions of paragraphs 1 through 3 and 5 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as previously amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FASB, *Current Text*, vol. 1, sec. C51), and would amend ARB 51 to extend its provisions to not-for-profit organizations. It also would supersede or amend other accounting pronouncements listed in appendix C of the exposure draft.

.158 The proposed Statement would be effective for financial statements for annual periods beginning after December 15, 1999, and all interim periods in the year of adoption. Earlier application would be encouraged. The proposed Statement would be applied by restatement of comparative financial statements for earlier periods. However, retroactive restatement would not be required for those entities for which (a) control was relinquished or (b) management has committed to a plan to relinquish control or is obligated to do so and that relinquishment is likely to occur within one year of the fiscal year-end in which this proposed Statement is first applied.

## Business Combinations

*What recent activity has taken place with respect to the FASB's business combinations project, and what is the significance of this issue to not-for-profit organizations?*

.159 On December 15, 1998, the FASB issued an Invitation to Comment, *Methods of Accounting for Business Combinations: Recommendations of the G4+1 for Achieving Convergence*, seeking comments on the views expressed in the G4+1 position paper. The G4+1 is an international group of standard setters that consists of representatives from the accounting standards boards of Australia, Canada, New Zealand, the United Kingdom, and the United States. The fundamental issues that the G4+1 position paper addresses are (1) whether a single method of accounting for business combinations is preferable to two (or more) methods, (2) if so, which method of accounting should be applied to all business combinations, and (3) if not, which methods should be applied and to which combinations they should be applied. The position paper concludes that the use of a single method of accounting is preferable and that the purchase method is the appropriate method to use. The due date for comments was February 15, 1999.

.160 One reason this issue is significant to not-for-profit organizations is that, in many combinations of not-for-profit organizations, the pooling method is currently used in conformity with GAAP. However, if

only the purchase method is allowed, not-for-profit organizations may be required to incur additional costs, for such items as appraisals and valuations.

.161 The FASB plans to discuss issues raised in the invitation to comment in the first quarter of 1999, and issue an exposure draft that would amend APB Opinion 16, *Business Combinations*, in the second quarter of 1999. Also, as reported in a recent FASB Alert, the FASB decided at its March 31, 1999, meeting to address issues specific to combinations of not-for-profit organization as a separate subproject, conducted concurrently with the main business combinations project.

## Agency Transactions

### *What is the status of the FASB's project with respect to not-for-profit organizations that raise contributed resources for others?*

.162 In July 1998, the FASB released an exposure draft of a proposed Statement, *Transfers of Assets Involving a Not-for-Profit Organization That Raises or Holds Contributions for Others*.<sup>9</sup> The proposed Statement would establish accounting standards for transfers of assets involving a not-for-profit organization that raises or holds contributions for others.

.163 Paragraph 4 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, 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." The proposed Statement would clarify the use of the terms *agent*, *trustee*, and *intermediary* in that paragraph, and establish standards for transfers to those organizations and other not-for-profit organizations that serve as recipient organizations. It would also establish standards for the specified organizations that benefit from those transfers.

.164 The proposed Statement would apply to transactions in which an entity—the *donor*—makes a contribution by transferring assets to a not-for-profit organization—the *recipient organization*—that accepts the assets from the donor and agrees to use those assets on behalf of or transfer those assets, or both, to another organization—the *beneficiary*—that is specified by the donor. It would also apply to transactions that take place in a similar manner but are not contributions because the transfers are revocable, repayable, or reciprocal.

.165 The proposed Statement would require a recipient organization that accepts cash or other financial assets from a donor and agrees to disburse them to a specified beneficiary to recognize the fair value of those assets as a liability to the specified beneficiary concurrent with recognition of the assets received from the donor. However, if the donor grants the recipient organization variance power or if the recipient organization and the specified beneficiary have a relationship that is characterized by one organization having an ongoing economic interest in the net assets of the other, the recipient organization would be required to recognize the fair value of any assets it receives as a contribution received.

.166 The proposed Statement would not establish standards for a trustee's reporting of assets held on behalf of specified beneficiaries but would establish standards for a beneficiary's reporting of its interests in those assets.

.167 The proposed Statement would require that a specified beneficiary recognize its interest in the assets held by a recipient organization as an asset unless the recipient organization has variance power. If the beneficiary and the recipient organization have a relationship characterized by one having an ongoing economic interest in the net assets of the other, the beneficiary would be required to recognize its interest in the net assets of the recipient organization and adjust that interest for its share of the change in net assets of

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<sup>9</sup> A final Statement is expected in the second quarter of 1999.

the recipient organization. That accounting is similar to the equity method. If a recipient organization has variance power, the specified beneficiary would not recognize its potential interest in the assets held by the recipient organization. In all other cases, a beneficiary would recognize its interest as a receivable.

.168 The proposed Statement describes four circumstances in which a transfer of assets to a recipient organization would be accounted for as a refundable advance because the transfer is revocable or reciprocal. Those four circumstances are if—

1. The transfer is subject to the resource provider's unilateral right to redirect the use of the assets to another beneficiary.
2. The transfer is accompanied by the resource provider's conditional promise to give or is otherwise revocable or repayable.
3. The resource provider controls the recipient organization.
4. The resource provider specifies itself or its affiliate as the beneficiary and the transfer is not an equity transfer.

An equity transfer is recorded by the resource provider as an interest in the net assets of the recipient organization or an increase in that interest. The recipient organization records an equity transfer as part of its change in net assets separately from revenue, expenses, gains, and losses.

.169 The proposed Statement would incorporate without reconsideration the guidance in FASB Interpretation No. 42, *Accounting for Transfers of Assets in Which a Not-for-Profit Organization Is Granted Variance Power*, and would supersede that Interpretation.

.170 The proposed Statement would be effective for financial statements issued for fiscal periods beginning after June 15, 1999, except for the provisions incorporated from Interpretation No. 42, which will continue to be effective for fiscal years ending after September 15, 1996. Earlier application would be encouraged. This proposed Statement would be applied either by restating the financial statements of all years presented or by recognizing the cumulative effect of the change in accounting principle in the year of the change.

## Disclosures About Pensions and Other Postretirement Benefits

.171 Often, one of the significant items disclosed in the financial statements of a not-for-profit organization is pension and other postretirement benefits. FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (FASB, *Current Text*, vol. 1, secs. P16, P40), issued in February 1998, makes a number of changes in the disclosure requirements, such as reduced disclosure requirements for nonpublic entities, including most not-for-profit organizations.<sup>10</sup>

.172 FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statement Nos. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16); 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, sec. P16); and 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40), were issued. FASB Statement No. 132 suggests combined formats for presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

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<sup>10</sup> In general, FASB Statement No. 132 defines a nonpublic entity as one whose debt or equity securities trade in a public market, one that makes a filing with a regulatory agency in preparation for the sale of securities, or one that is controlled by an entity covered by the first two types of entities mentioned.

.173 FASB Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

## Derivatives and Hedging Activities

.174 Not-for-profit organizations that make significant use of derivative instruments as part of their financial strategies may be particularly affected by a new pronouncement in this area—FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50), issued in June 1998. For example, a not-for-profit organization may use derivatives as part of its investment strategy or as part of a strategy to reduce risk on foreign-currency transactions. Additionally, many not-for-profit organizations do not realize they have derivatives, but they may have embedded derivatives in such items as lease agreements, insurance policies, bonds, and financial guarantees.

.175 FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction, or (c) a hedge of the foreign-currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.176 FASB Statement No. 133 (paragraph 43) includes certain provisions regarding accounting by not-for-profit organizations and other entities that do not report earnings:

“An entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization or a defined benefit plan pension plan) shall recognize the gain or loss on a hedging instrument and a nonhedging derivative instrument as a change in net assets in the period of change unless the hedging instrument is designated as a hedge of the foreign-currency exposure of a net investment in a foreign operation. In that case, the provisions of paragraph 42 of this Statement shall be applied. Entities that do not report earnings shall recognize the changes in the carrying amount of the hedged item pursuant to paragraph 22 in a fair value hedge as a change in net assets in the period of change. Those entities are not permitted to use cash flow hedge accounting because they do not report earnings separately. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, this Statement does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.”

.177 Statement No. 133 (paragraphs 44 through 47) also contains extensive disclosure requirements. FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. However, the FASB has issued an exposure draft dated May 20, 1999, of the proposed Statement titled “Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133,” which would amend FASB Statement No. 133 to defer its effective date to all fiscal quarters of all fiscal years beginning after June 15, 2000. The comment deadline is June 19, 1999. Readers should refer to the full text of the Statement and any related amendments to it when considering accounting and reporting issues related to derivative instruments and hedging activities.

## **Listing of Recent Auditing, Attestation, and Accounting Pronouncements<sup>11</sup>**

### **New Auditing Standards**

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- SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), issued in March 1998 (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), issued in September 1998 (See discussion in the section titled "Restricted-Use Reports" in this *Audit Risk Alert*.)
- SAS No. 21, *Segment Information—Rescinded* (AICPA, *Professional Standards*, vol. 1, AU sec. 435) (Note that SAS No. 21 referred to the superseded FASB Statement No. 14, which exempted not-for-profit organizations. See the explanation in the *Audit Risk Alert—1998/99* [AAM section 8010].)

### **New Attestation Standards**

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- SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 9700), issued in March 1998 (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SSAE No. 9, *Amendments to Statement on Standards for Attestation Engagements Nos. 1, 2, and 3* (See the discussion in the section titled "Attestation Engagements" in this *Audit Risk Alert*.)

### **New Auditing Interpretations**

.180 Auditing Interpretations are issued by the AITF of the ASB to provide timely guidance on the application of ASB pronouncements. Interpretations are reviewed by the ASB but are not as authoritative as ASB pronouncements. Nevertheless, a departure from an Interpretation may have to be justified if the quality of a member's work is questioned. Interpretations become effective upon their publication in the *Journal of Accountancy*. Summaries of the recently issued Interpretations are included in the *Audit Risk Alert—1998/99* [AAM section 8010].

- Interpretation No. 4, "Audit Considerations for the Year 2000 Issue," of AU Section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311), issued in January 1998
- Interpretation No. 1, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125," of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336), issued in February 1998
- Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324), issued in March 1998
- Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341), issued in July 1998

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<sup>11</sup> Specific exemptions related to not-for-profit organizations have been noted here. Readers should refer to the complete text of pronouncements to determine whether they are applicable in a particular situation.

- Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326), issued in August 1998 (Note that this Interpretation refers to FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*, which exempts not-for-profit organizations.)
- Interpretation No. 3, "Commenting in a Comfort Letter on Quantitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K," of SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9634), issued in August 1998

## New Attestation Interpretation

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- Interpretation No. 1, "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis," of SSAE No. 8, *Management's Discussion and Analysis*, issued in August 1998 (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)

## New Audit Issues Task Force Advisories

.182 From time to time the AITF issues AITF Advisories to provide nonauthoritative guidance on current developments or recently issued authoritative literature.

- AITF Advisory Concerning Comprehensive Income (Note that this AITF refers to FASB Statement No. 130, *Reporting Comprehensive Income* [FASB, *Current Text*, vol. 1, sec. C49], which exempts not-for-profit organizations that are required to follow FASB Statement No. 117. See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- AITF Advisory Concerning Practice Issues Regarding Language to Permit the Use of Legal Opinions by Auditors (Note that this Advisory was an intermediary document. It was replaced by the amended Interpretation to SAS No. 73, included in the preceding list under the heading "New Auditing Interpretations." See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- AITF Advisory Concerning Reporting the Adoption of SOP 98-2. (See the discussion in this Audit Risk Alert in the section titled "Joint Activities.")

## New FASB Pronouncements

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- FASB Statement No. 132 (See the discussion in the section titled "Disclosures About Pensions and Other Postretirement Benefits" in this Audit Risk Alert.)
- FASB Statement No. 133 (See the discussion in the section titled "Derivatives and Hedging Activities" in this Audit Risk Alert.)
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65* (FASB, *Current Text*, vol. 1, sec. Mo4) (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- FASB Statement No. 135, *Rescission of FASB Statement No 75 and Technical Corrections* (A summary will be included in the *Audit Risk Alert—1999/2000*, to be issued later in 1999.)
- FASB Technical Bulletin No. 97-1, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option* (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- The status of issues considered recently by the EITF of the FASB can be found in the *Audit Risk Alert—1998/99* [AAM section 8010] and the *Audit Risk Alert—1999/2000*. (Available later in 1999.)

## New AICPA Accounting and Auditing Statements of Position

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- SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, issued in March 1998 (See summary in the prior Audit Risk Alert, *Not-for-Profit Organization Industry Developments—1998*, and the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, issued in March 1998 (See the summary in the prior Audit Risk Alert, *Not-for-Profit Organization Industry Developments—1998*, and the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SOP 98-3, *Audits of States, Local Governments, and Not-For-Profit Organizations Receiving Federal Awards*, issued in March 1998 (See summary in the prior Audit Risk Alert, *Not-for-Profit Organization Industry Developments—1998* and the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*, issued in March 1998 (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SOP 98-5, *Reporting on the Costs of Start-Up Activities*, issued in April 1998 (See the discussion in the section titled “Start-Up Activities” in this Audit Risk Alert.)
- SOP 98-6, *Reporting on Management’s Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*, issued in April 1998 (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, issued in November 1998 (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SOP 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934, Rule 17Ad-18 of the Securities Exchange Act of 1934, and Advisories No.17-98 and No. 42-98 of the Commodity Futures Trading Commission*, issued in November 1998 (See the summary in the *Audit Risk Alert—1998/99* [AAM section 8010].)
- SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions* (A summary will be included in the *Audit Risk Alert—1999/2000*, to be issued later in 1999.)

## Nonauthoritative AICPA Audit and Accounting Products

### Industry Conference

.185 The AICPA will hold its Seventh Annual Not-for-Profit Organizations Industry Conference on June 14 to 15, 1999 (with a half-day optional session on June 16), in Washington DC. The conference is designed for both practitioners and not-for-profit organization financial executives, and will provide technical information for those decision makers. For further information, call the AICPA CPE Conference Hotline at (888) 777-7077 or visit the AICPA Web site at [www.aicpa.org](http://www.aicpa.org).

### Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organizations—Available Fall '99

.186 Bringing the same kind of effective guidance as the AICPA *Accounting Trends and Techniques*, this comprehensive, nonauthoritative Practice Aid will illustrate a wide variety of not-for-profit organizations financial statement formats and disclosures to assist auditors of not-for-profit organizations.

## Accounting and Auditing Technical Hotline

.187 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

## Ethics Hotline

.188 The AICPA Professional Ethics Team answers inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

## Continuing Professional Education Courses

.189 The AICPA offers many continuing professional education courses related to not-for-profit organizations, many of them available for both group study and self-study. Among the available titles are the following:

- Accounting and Reporting Practices of Nonprofit Organizations—Choices and Applications
- Audits of Public and Indian Housing Authorities
- Budget Building for Nonprofits
- Compensation Issues in Not-for-Profit Organizations
- Compliance Auditing
- Fraud in Governmental and Not-for-Profit Audits: The Auditor's Responsibility Under SAS No. 82
- Getting Started With Not-for-Profit Organization Tax Issues
- Government Auditing Standards and Compliance Auditing
- HUD Audits: A Comprehensive Guide (available in text and video)
- Managing Not-for-Profits in the New Accounting and Auditing Environment
- Nonprofit Accounting and Auditing Update (1999-2000 Edition) (available in text and video)
- Single Audit Requirements for Nonprofit and Governmental Organizations
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (available in text and video)
- Subrecipient Monitoring
- 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 (available in text and video)
- Yellow Book: Government Auditing Standards (available in text and video)

For more information about AICPA CPE courses, call the AICPA information hotline at (888) 777-7077 or visit the AICPA Web site at [www.aicpa.org](http://www.aicpa.org).

## Not-for-Profit Organizations Checklists

.190 The AICPA Technical Publications staff has developed various publications that may interest readers of this Audit Risk Alert. For example, an annual publication titled *Checklists and Illustrative Financial*



*Statements for Not-for-Profit Organizations* (Product No. 008681), is a nonauthoritative Practice Aid designed to help those preparing reports and financial statements of not-for-profit organizations.

### **Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations**

.191 This new two-volume set (Product No. 008730) contains comprehensive analyses of the OMB's revisions to its Circulars for performing Single Audits, numerous checklists and illustrative examples, and an illustrative case study of the single audit process.

### **Technical Practice Aids**

.192 *AICPA Technical Practice Aids* includes questions received by the AICPA Technical Information Service on various subjects and the service's response to those questions. Sections 6140 and 6960 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 hardcover form. See discussion of recently published additional *Technical Practice Aids* in the section titled "New AICPA Technical Practice Aids" in this Audit Risk Alert.

## **References for Additional Guidance**

### **Federal Agencies' Administrative Regulations**

.193 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*.

### **General Accounting Office**

.194 GAO publications include those listed in this section. Unless otherwise noted, requests for copies of these publications should be sent to the GAO, P.O. Box 37050, Washington, DC 20013. The telephone number is (202) 512-6000. Orders may also be placed by using the fax number (202) 512-6061. 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 email message with information in the body to [info@www.gao.gov](mailto:info@www.gao.gov).

#### *Government Auditing Standards, 1994 Revision*

.195 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, Superintendent of Documents, Washington, DC 20401; telephone (202) 783-3238; telefax (202) 512-2250; Stock No. 020-000-00-265-4. An interactive version of *Government Auditing Standards* is available on the ignet home page (<http://www.ignet.gov>). Auditors should note that the GAO is currently working on revisions to *Government Auditing Standards* (see the related discussion in the section of this Audit Risk Alert titled "Regulatory and Legislative Developments").

### *Interpretation of Continuing Education and Training Requirements*

.196 This provides guidance to audit organizations and individual auditors on implementing the CPE requirements of *Government Auditing Standards*. This Interpretation (April 1991, 020-000-00250-6) is available from the GPO, Superintendent of Documents, Washington, DC 20401.

### *How to Get Action on Audit Recommendations*

.197 This guide is designed 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).

## **Office of Management and Budget**

### *Circulars*

.198 The 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 not-for-profit organizations are as follow:

- A-21, *Cost Principles for Educational Institutions*
- A-110, *Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*
- A-122, *Cost Principles for Non-Profit Organizations*
- A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

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 Web site <http://www.whitehouse.gov/OMB>. An alternate address is the ignet Web site at <http://www.ignet.gov>. A separate discussion of OMB Circulars relevant to audits of not-for-profit organizations is included in the section of this Audit Risk Alert titled "Regulatory and Legislative Developments."

### **OMB Circular A-133 Compliance Supplement**

.199 The OMB *Compliance Supplement*, issued as a provisional document on June 30, 1997, and subsequently superseded by the 1998 and 1999 *Compliance Supplements*, sets forth the major federal compliance requirements that should be considered in a single audit of states, local governments, and not-for-profit organizations that receive federal awards. A separate discussion of recent revisions to the *Compliance Supplement* is included in the section of this Audit Risk Alert titled "Regulatory and Legislative Developments."

### *The Catalog of Federal Domestic Assistance*

.200 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 Web site, which is currently located at <http://www.gsa.gov/fdac>.

.201 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.

.202 Program information is also available on CD-ROM and diskettes. These may be purchased by writing the Federal Domestic Assistance Catalog Staff (MVS), General Services Administration, Reporters Building, Room 101, 300 Seventh Street, SW, Washington, DC 20407, or calling (202) 708-5126.

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.203 This Audit Risk Alert replaces *Not-for-Profit Organization Industry Developments—1998*. The *Not-for-Profit Organization Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may email these comments to [sfrohlich@aicpa.org](mailto:sfrohlich@aicpa.org) or write to:

Susan Frohlich, CPA—New York  
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Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

.204 Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1998/99* [AAM section 8010] (Product No. 022223) and *Compilation and Review Alert—1998/99* [AAM section 8010] (Product No. 022222), which may be obtained by calling the AICPA Order Department at (888) 777-7077. (The 1999/2000 version of these publications will be issued later in 1999.)

## Appendix

### The Internet—An Auditor's Research Tool

#### Can auditors use the Internet to perform more efficient audits?

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to industry statistics, resources for not-for-profit organizations and their finance professionals, professional news, state CPA society information, Internal Revenue Service information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, often free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to—

- Obtain audit and accounting research information.
- Obtain texts, such as audit programs.
- Discuss audit issues with peers.
- Communicate with audit clients.
- Obtain information from a client's Web site.
- Obtain information on professional associations.

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; caution is advised when accessing data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
American Institute of CPAs	Information for CPAs on accounting, auditing, industry activities, the activities of the AICPA, and other matters	<a href="http://www.aicpa.org">http://www.aicpa.org</a>
Accountant's Home Page	Resources for accountants and financial and business professionals	<a href="http://www.computercpa.com/">http://www.computercpa.com/</a>
Action Without Borders	Includes a directory of not-for-profit organizations and volunteering resources, a newsletter on not-for-profit organization issues, and job postings	<a href="http://www.idealists.org">http://www.idealists.org</a>
American Society of Association Executives	Provides resources to assist association executives and individuals from for-profit companies that provide products and services to the association community	<a href="http://www.asaenet.org">http://www.asaenet.org</a>

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
AuditNet	Electronic communications among audit professionals	<a href="http://www.cowan.edu.au/mra">http://www.cowan.edu.au/mra</a>
The Chronicle of Philanthropy	Articles from the <i>Chronicle of Philanthropy</i> newspaper and links to other sites	<a href="http://philanthropy.com">http://philanthropy.com</a>
Council on Foundations	Includes research, publications, and other information of interest to foundations and corporate donors	<a href="http://www.cof.org">http://www.cof.org</a>
CPAnet	Links to other Web sites of interest to CPAs	<a href="http://www.cpalinks.com/">http://www.cpalinks.com/</a>
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	<a href="http://www.cybersolve.com/tools1.html">http://www.cybersolve.com/tools1.html</a>
The Electronic Accountant	World Wide Web magazine that features up-to-the minute news for accountants	<a href="http://www.electronicaccountant.com">http://www.electronicaccountant.com</a>
Financial Accounting Standards Board	Information on the activities of this standard-setting body	<a href="http://www.fasb.org">http://www.fasb.org</a>
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	<a href="http://www.fedworld.gov">http://www.fedworld.gov</a>
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory	<a href="http://www.fsforum.com">http://www.fsforum.com</a>
The Foundation Center	Information for not-for-profit organizations, donors, and researchers	<a href="http://www.fdncenter.org">http://www.fdncenter.org</a>
Giving USA	American Association of Fund-Raising Counsel sponsored site providing information trends in giving and sources of support	<a href="http://www.aafr.org">http://www.aafr.org</a>
General Accounting Office	Policy and guidance materials, reports on federal agency major rules	<a href="http://www.gao.gov">http://www.gao.gov</a>
Guidestar	Information on not-for-profit organizations and new and resources for not-for-profit organizations and donors	<a href="http://www.guidestar.org">http://www.guidestar.org</a>
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	<a href="http://www.tetranet.net/users/gaostl/guide.htm">http://www.tetranet.net/users/gaostl/guide.htm</a>
Hoovers Online	Online information on various companies and industries	<a href="http://www.hoovers.com">http://www.hoovers.com</a>
Independent Sector	A forum to encourage giving, volunteering, not-for-profit initiative and citizen action	<a href="http://www.indepsec.org">http://www.indepsec.org</a>

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Information for Tax-Exempt Organizations (an IRS site)	A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt organizations	<a href="http://www.irs.ustreas.gov/prod/bus_info/eo">http://www.irs.ustreas.gov/prod/bus_info/eo</a>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.kentis.com/ib.html">http://www.kentis.com/ib.html</a>
Internet Nonprofit Center	Includes the nonprofit locator, frequently asked questions, and other information	<a href="http://www.nonprofits.org">http://www.nonprofits.org</a>
Management Assistance Program for Nonprofits	Includes the Nonprofit Manager's Library and other resources	<a href="http://www.mapnp.org">http://www.mapnp.org</a>
National Association of College and University Business Officers	Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting	<a href="http://www.nacubo.org">http://www.nacubo.org</a>
The National Center for Nonprofit Boards	Resources to help strengthen not-for-profit organization boards of directors	<a href="http://www.ncnb.org">http://www.ncnb.org</a>
The National Center for Charitable Statistics	Provides statistics on revenue and expenses of not-for-profit organizations	<a href="http://urban.org">http://urban.org</a>
National Charities Information Bureau	Promotes giving and helps contributors obtain accurate information about charitable organizations	<a href="http://www.give.org">http://www.give.org</a>
The Nonprofit Genie	Advice, links to other sites, publications, and other information on not-for-profit organization management	<a href="http://www.genie.org">http://www.genie.org</a>
The Nonprofit Resource Center	Information and links to other sites covering financial management, governance, legal, and other matters	<a href="http://www.not-for-profit.org">http://www.not-for-profit.org</a>
The Nonprofit Risk Management Center	Provides information to help not-for-profit organizations control their risks	<a href="http://www.nonprofitrisk.org">http://www.nonprofitrisk.org</a>
The Nonprofit Times Online	Articles from the <i>Nonprofit Times</i> newspaper and links to other sites	<a href="http://www.nptimes.com">http://www.nptimes.com</a>
Support Center for Nonprofit Management	Workshops, consulting, publications, and other information and resources of interest to managers of not-for-profit organizations	<a href="http://www.supportcenter.org">http://www.supportcenter.org</a>
Tax Analysts Online	Provides information on current tax developments	<a href="http://www.tax.org">http://www.tax.org</a>
U.S. Department of Education	Information on programs, resources, and other matters	<a href="http://www.ed.gov">http://www.ed.gov</a>
U.S. Tax Code Online	A complete text of the U.S. Tax Code	<a href="http://www.fourmilab.ch/ustax/ustax.html">http://www.fourmilab.ch/ustax/ustax.html</a>

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
U.S. Office of Management and Budget	OMB information and literature	<a href="http://www.whitehouse.gov/OMB/">http://www.whitehouse.gov/OMB/</a>
Vision Project	Information on the profession's Vision Project	<a href="http://www.cpavision.org/horizon">http://www.cpavision.org/horizon</a>

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# AAM Section 8130

## *High-Technology Industry Developments—1998/99*

### In This Year's Alert . . .

- What significant industry and economic events and conditions have occurred recently that are relevant to the audits of high-technology entities?
- What significant recent events have occurred involving the high-technology industry segments regulated by the FCC?
- What action has Congress taken to help deal with the Year 2000 Issue?
- Does the current industry and economic environment pose additional considerations regarding an entity's ability to continue as a going concern and what impact will this have on audits of high-technology entities?
- Will the Asian crisis have an impact on high-technology audits this year?
- Why is the risk of client fraud of particular concern to auditors of high-technology entities?
- How does the trend towards merger and consolidation in the high-technology industry affect auditors of high-technology entities?
- What are some of the auditing and accounting issues of concern to the SEC regarding disclosures about restructuring charges and liabilities recognized in connection with purchase business combinations?
- How does the issue of inventory valuation affect auditors of high-technology audit clients?
- What types of illegal acts should the auditor be aware of in the high-technology industry?
- What is the Year 2000 Issue and how does it affect high-technology audit clients and their auditors?
- What new auditing and attestation pronouncements have been issued this year?
- What significant factors should the auditor consider with respect to revenue recognition for high-technology audit clients?
- What recent guidance has been issued with respect to accounting for the costs of internal use computer software?
- What guidance is available regarding accounting for the costs of computer software to be sold, leased, or otherwise marketed?
- What are the current significant issues with respect to in-process research and development in a purchase business combination?
- What new accounting pronouncements have been issued this year by the FASB?
- What new AICPA accounting and auditing SOPs have been issued this year?
- Can auditors use the Internet to perform more efficient audits?

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## Industry and Economic Developments

*What significant industry and economic events and conditions have occurred recently that are relevant to the audits of high-technology entities?*

.01 Even though the term *high-technology* is not precisely defined, it is generally considered to refer to activities that employ scientific theories and applications to develop new products that enhance productivity. The high-technology industry, according to the American Electronics Association, includes nine subgroups of manufacturing: computers, consumer electronics, communications equipment, electrical components, semiconductors, defense electronics, industrial electronics, electromedical equipment, and photonics, and two subgroups of services: telecommunications services, and software and computer services. Shown in the following sections are brief descriptions of current events in some of these industries, followed by a discussion of some of the resulting audit issues that are generally applicable to many segments of the high-technology industry.

### Computers and Peripherals

.02 The computer and peripherals segment has had a difficult year. Industry analysts expect worldwide unit volume for personal computers (PCs) to increase 11 percent to 14 percent over 1997, a drop from the high-teens increase of last year. Also, many entities in this segment had to deal with excess inventories from the beginning of the year, along with price cutting, and a growing demand for PCs costing less than a thousand dollars. Not only have these conditions put pressure on margins for computer makers, but they also may accelerate the rate of return and price protection claims from resellers. One of the difficult issues in the computer and peripherals segment of the industry, and some other high-technology areas as well, is estimating the amount of returns and price protection claims. This difficulty results because it is difficult to know the amount of inventory that is still in the distributor channels that will not be sold and will be returned. In such circumstances, auditors should consider the guidance in Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342). Also, a discussion of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists* (FASB, *Current Text*, vol. 1, sec. R75), is included in the section titled "Revenue Recognition" in the "Accounting Issues and Developments" section of this Audit Risk Alert. Another related issue is: If the manufacturers push too much inventory to distributors and it ends up being returned, this could affect the valuation of inventory at lower of cost or market.

.03 In the international market, the slumping economies in Asia have affected the computer and peripherals industry. Although this area has previously shown significant growth, accounting for 20 percent to 25 percent of product sales, sales in Asia have deteriorated. Also, revenue from sales already made in Asia may also be affected, in that the related receivables may experience a high rate of credit loss.

.04 Some industry analysts foresee a possible bounce back later this year and into 1999, predicated on inventory levels moving back to normal and strong consumer demand for PCs selling at less than \$1,000. However, although unit sales may increase, it is also likely that revenue may be down in 1999 due to business customers spending on correcting the year 2000 problem and on modifying financial information systems for the Euro<sup>1</sup> currency, at the expense of spending on new hardware.

### Semiconductors

.05 This year has also been difficult for the semiconductor industry, with analysts forecasting double-digit rates of decline in sales revenue for 1998. Reasons for the poor results include the following:

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<sup>1</sup> On January 1, 1999, the European Economic and Monetary Union (EMU) goes into effect. Under the EMU, only one reporting currency will exist—the Euro. From that point on, every entity that trades with or has subsidiaries in Europe will be affected by the change to a common currency. A discussion of this issue is included in *Audit Risk Alert—1998/99* [AAM section 8010].

- Excess plant capacity, resulting in falling prices for some products. The previous expansion in demand for semiconductors for use in PCs and other products led to large business investments in high-production facilities.
- The countries in Asia, formerly emerging sales markets, have become significant competitors in the semiconductor industry.
- Profit margins have been affected by the popularity of the inexpensive computers because margins for microprocessors and other components for the cheaper PCs tend to be lower than those of the more powerful and expensive models.

The above-mentioned overcapacity for some products, such as memory chips, has resulted in the closing of facilities or the scaling back of facilities commitments. These circumstances may call into question the recoverability of the carrying amount of certain plant assets. Accordingly, auditors should evaluate the client's consideration of the guidelines set forth under FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. 108).

.06 Also, in these circumstances, manufacturing need may have decreased to the degree that it affects such matters as the number of employees or the amount of plant capacity needed. Accordingly, the auditor should consider whether management has addressed relevant accounting guidance, including 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)*.

.07 Also, if prices drop due to such factors as overcapacity, inventories may not be properly stated at lower of cost or market valuation.

.08 However, some analysts predict that the semiconductor industry is likely to bounce back in 1999, as capacity declines. Also, some expect that over the next few years, the dominance of PCs in driving the semiconductor industry will decline. The growing markets for semiconductors include telecommunications, data networking, consumer-electronics, and Internet access appliances.

## Electronic Products and Components

.09 Although many people think primarily about computers when using the term *high technology*, many types of electronics products and electrical components use sophisticated and cutting-edge technology, and can be considered part of the high-technology market. Electrical components include electron tubes, printed circuit boards, electronic capacitors, electronic resistors, transformers, and other such items, which are used in many industries, including computers, telecommunications, medical equipment, and consumer products.

.10 Product oversupply, price competition, and reduced demand have resulted in a difficult year for electronics entities. The constantly changing uses of electronic components also results in risks for electronics manufacturers, as product demand can change rapidly. Products become obsolete more quickly as new products take hold. As in other areas of the high-technology industry, significant expenditures are needed for research and development to be ready for the next product wave. However, some analysts predict that the increasing number of electronic components in various products will benefit this segment going forward.

## Computer Software and Services

.11 Because the computer software and services segment of the high-technology industry usually makes about one quarter of its sales outside the U.S., it has also been hurt by the problems overseas, particularly in Asia. This includes the effect of the Asian crisis on U.S. customers that may cut spending plans on computer software and services. Other problems faced by entities in this industry segment this year may include—

- A decrease in spending by customers on computer software and services to offset increases in spending on fixing potential problems from the Year 2000 Issue and the conversion to the Euro.
- The potential that the year 2000 problem will cause errors in computer application products and services sold to customers.

See the section titled "The Year 2000 Issue" in the "Audit Issues and Developments" portion of this Audit Risk Alert, which discusses the various aspects of this problem, including the increased risk of litigation.

.12 However, some segments of the industry may also benefit from both the year 2000 problem and the Euro conversion. Entities that are successfully addressing the issues with computer applications, consulting, and installation services may see revenue increases in the near term. However, the resulting growth rate for these entities may not be sustainable over the long-term.

.13 As purchasers of computer software and services address rapid changes in technology and need more computer support to function efficiently in a more computer-oriented environment, the transactions entered into by computer software and services companies can also become more complex. For example, an arrangement to deliver software or a software system may require significant production, modification, or customization of software, or the software arrangement may consist of multiple elements, such as additional software products, upgrades, and postcontract customer support. Other types of changes (for example, the conversion to the Euro) also may present situations in which customers require upgrades. Issues such as these can make the accounting for software revenue more complex also. A further discussion of some of these revenue recognition issues is included in the section titled "Revenue Recognition" in the "Accounting Issues and Developments" section of this Audit Risk Alert.

.14 Also, many companies are choosing to focus on their main operations, and outsourcing specific functions, such as payroll processing, or the entire data processing operations, to software service providers. Auditors of such software service providers, as well as the auditors of the service providers' clients, should be familiar with the requirements of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). SAS No. 70 provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. SAS No. 70 also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

## Internet Services

.15 Internet usage is increasing rapidly, primarily due to the availability of low-cost PCs. Because of low barriers to entry, entities can easily enter this market. With the increase in start-up enterprises involved in the Internet industry, the auditor may need to assess management's consideration and application of relevant standards, such as the guidance set forth in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises* (FASB, *Current Text*, vol. 2, sec. De4), and AICPA Statement of Position (SOP) 98-5, *Reporting on the Costs of Start-Up Activities*.

.16 This industry changes rapidly and substantial expenditures are needed to build traffic levels. Although some entities are still unprofitable, investors may see them as successful when looking at the number of visits on their sites, rather than their earnings (which usually come from subscriber fees or advertisers who pay to be on the site). Stock prices can have significant fluctuations even though there has been no change in the entity's financial status, and the price/earnings ratio on Internet stocks often far exceed that of other technology entities.

.17 Although there has been some significant merger activity in the high-technology industry in general, the Internet segment has been one of the areas particularly affected by this trend (others include the telecommunications and software segments). Some of the accounting treatment, in particular, that concerning

in-process research and development, has been called into question by the SEC. A further discussion of this issue is included in the section titled “In-Process Research and Development in a Purchase Business Combination” in the “Accounting Issues and Developments” portion of this Audit Risk Alert.

## Telecommunications Services

.18 Competition in the telecommunications industry has been, and will continue to be, affected by the Telecommunications Act of 1996 (the Act). The Act was passed with the intention of deregulating and fostering competition in the telecommunications market. It provides that long-distance and local phone companies can enter each other’s markets. The local exchange carriers (LECs), primarily the regional Bell operating companies (RBOCs), cannot offer long-distance services to local customers until they first open up their own markets to allow for local competition. Some RBOCs are attempting to win federal approval to provide long-distance services to local customers. However, none has yet been successful in convincing the Federal Communications Commission (FCC) that it has opened up its markets to competition, which is a requirement before being allowed to offer long-distance service to local customers.

.19 In response to the market deregulation and changes in technology, there is a growing trend for various types of telecommunications entities to offer new services. For example—

- The RBOCs are attempting to win federal approval to enter long-distance markets.
- Cable companies are entering the phone service business.
- Long-distance phone companies are entering into mergers with cable companies to obtain the local infrastructure needed to provide local phone services and other services, such as Internet and data services, without going through the LECs.

Many entities in the telecommunications industry want to offer new services, including complete packages of local, long-distance, and international voice service, cable access, Internet and data services, and interactive video. To do so, they may need to replace old equipment. Accordingly, auditors should consider whether the client has, where applicable, properly accounted for such circumstances and events pursuant to the guidelines set forth under FASB Statement No. 121.

.20 There are also significant issues with respect to the FCC’s auction of personal communications services (PCS) licenses. PCS is a cellular service, except it is entirely digital and may use a higher frequency spectrum. These licenses were sold in blocks (A through E) that have specific requirements to cover a percentage of the potential subscribers by fixed dates or forfeit the license. The auction of C block licenses brought higher prices than previous block auctions. Many of the C block licensees cannot pay the fees, and some have filed for bankruptcy. In June of 1998, debtor C block licensees had to choose from various options offered by the FCC to address their debts, such as returning the license. In addition to paying attention to the terms of the client’s PCS license, auditors of C block licenses need to pay attention to the option selected by the client in order to assess the manner in which the elements of that transaction, such as a forfeited deposit, have been accounted for. The auditor may also need to address going-concern issues.

## Telecommunications Equipment

.21 Because equipment manufacturers are so heavily affected by the telecommunications entities, auditors might benefit from an understanding of the developments in both industries and how they work together. For example, the local phone service business is still dominated by a few large carriers, which may increase their ability to bargain or renegotiate contract terms. Equipment suppliers may have committed significant amounts of resources in fulfilling a contract with one of the large telecommunications entities, which may have more bargaining power than originally intended. These goods may not be saleable elsewhere, and contract or product changes, such as a right of return, may be allowed that were not originally anticipated.

.22 On the other side are the risks faced by telecommunications equipment manufacturers when dealing with the small, start-up telecommunications entities, in particular, the radiotelephone communications entities, such as cellular, paging, and personal communications services entities. Some of these start-up telecommunications entities often want the equipment manufacturers to help finance purchases by allowing long-term receivables, leasing arrangements, and other arrangements. Special sales arrangements and their effect on revenue recognition may need to be considered by the auditor.

.23 See a further discussion of revenue recognition issues in the section titled "Revenue Recognition" in the "Accounting Issues and Developments" portion of this Audit Risk Alert.

#### **Executive Summary—Industry and Economic Developments**

- Many entities in the high-technology industry may be experiencing uncertainty regarding continued profitability due to such factors as decreasing profit margins and heavy competition. A further discussion of these issues is included in the section titled "Going Concern Issues" in the "Audit Issues and Developments" portion of this Audit Risk Alert.
- The Asian crisis, the resulting pressures on other economies, and the recent troubles in Russia and Latin America have numerous implications for the high-technology industry. See the discussion in the section titled "The Crisis in Asia" in the "Audit Issues and Developments" portion of this Audit Risk Alert.
- In many segments, particularly telecommunications and Internet, there is significant merger activity. A more detailed discussion of this issue is included in the section titled "Business Combinations" in the "Audit Issues and Developments" portion of this Audit Risk Alert.
- Rapid changes in technology are common to the high-technology industry and can affect inventory obsolescence and increase returns. See the section titled "Inventory Valuation" in the "Audit Issues and Developments" portion of this Audit Risk Alert. Also see the discussion of revenue recognition when right of return exists in the section titled "Revenue Recognition" in the "Accounting Issues and Developments" portion of this Audit Risk Alert.
- The rapid changes in technology also create a need to provide additional products and services, such as upgrades and postcontract customer support. The auditor should note that this issue is also applicable to entities other than traditional software providers. See the section titled "Revenue Recognition" in the "Accounting Issues and Developments" section of the Audit Risk Alert for additional information on accounting for these types of arrangements.
- The year 2000 problem can present both risks and opportunities—the risk of year 2000 problems affecting operations, products, and services, and the opportunities to solve those problems for clients. This issue is discussed in the section titled "The Year 2000 Issue" in the "Audit Issues and Developments" portion of this Audit Risk Alert.

## **Legislative and Regulatory Developments**

### **Federal Communications Commission Issues**

*What significant recent events have occurred involving the high-technology industry segments regulated by the FCC?*

.24 The FCC regulates aspects of many industries, including cable, satellite, wireless, telecommunications common carriers, and broadcasting. As the industry changes and technology advances, the regulations will also change. These changes may have significant effects on high-technology clients. They may be allowed to compete in new areas; previously unregulated services may be regulated; competition may increase significantly as markets are opened up; or competition may even decrease if an allowed merger results in control by one or a few entities of a segment of the market. Two areas that continue to be rapidly changing are the regulations under the Telecommunications Act of 1996 (the Act) and access to the Internet from Internet service providers.

### *The Telecommunications Act of 1996*

.25 On February 1, 1996, Congress passed the Act, which represented the first-ever comprehensive rewrite of United States communications law and is the most sweeping reform of FCC policy enacted in decades. The Act was passed with the intention of deregulating the telecommunications market to foster competition at the local level while allowing the RBOCs access to the long-distance market. Among its provisions is that an RBOC is barred from providing long-distance service to its local customers. The Act says an RBOC must open its market to competitors and obtain FCC approval before it may provide long-distance services to local customers. No RBOC has received FCC approval.

.26 Although competition is increasing, over 90 percent of the revenue from wireline service is still controlled by fewer than a dozen large companies, including the RBOCs and a few large long-distance companies. However, there are many smaller wired and wireless telephone services companies, some using leased lines or reselling services of other providers.

.27 What has made the increase in competition so slow may be the regulatory and legal confrontations surrounding the implementation of the Act. As these events unfold, they can directly affect clients in this industry segment. A few of the recent court decisions and events are highlighted here:

- In August, the U.S. Court of Appeals for the Eighth Circuit in St. Louis upheld the FCC's decision requiring the Baby Bells to share with competitors access to their network's full capabilities, not just leased access to a portion of the networks.
- In August, the U.S. Court of Appeals for the Eighth Circuit in St. Louis upheld certain FCC regulations meant to lower long-distance telephone rates by lowering access charges paid by the long-distance companies to the LECs.
- In October, the Supreme Court heard arguments covering various aspects of the FCC's "interconnection order," which required that local telephone companies offer discounts to competitors that want to use their networks. The interconnection order also gave most of the jurisdiction regarding pricing to the FCC rather than the states. The U.S. Court of Appeals for the Eighth Circuit in St. Louis had previously ruled that the FCC overstepped its bounds in setting local competition price rules and vacated key provisions of the order.

As can be seen from these examples, in this continuously changing environment, new issues continue to be raised for resolution by the courts. Their decisions can have dramatic effects on clients in the high-technology field. Auditors need to continue to monitor developments and their effects on clients.

### *Internet Services*

.28 Because technology is changing so rapidly, the FCC is sometimes faced with attempting to apply rules that were not drafted to take these changes into account. One such situation is the area of Internet services delivered over cable-television wires. In September, the FCC issued a working paper to obtain industry and consumer comment to help it answer the question, Is Internet over cable a cable service, a telecommunications service, or an information service?

- If defined as cable services, these services may be subject to regulatory oversight. Also, as cable services they may be forced to pay franchise fees to local governments, which would, in turn, raise consumer prices for cable Internet services.
- If they are regulated as telecommunication carriers, they may be required to share their networks with competitors.
- If they are considered information services, they may be exempt from regulation.

The significance of this issue will become greater over time because, according to some researchers, it is estimated that within the next four years, about 25 percent of all U.S. households will use high-speed con-

nections to access the Internet, and cable companies will have an 80 percent share of the residential fast Internet market.

## Millennium Bug Legislation

### *What action has Congress taken to help deal with the Year 2000 Issue?*

.29 A bill recently signed by President Clinton, called the Year 2000 Information and Readiness Disclosure Act, is intended to encourage businesses to share information on how to deal with the year 2000 computer crisis. As a result, the problem may be addressed more quickly. Among its provision, the bill—

- Establishes a government Web site as a clearinghouse for basic information for consumers, small businesses, and local government.
- Offers limited liability protection for companies that share information about the year 2000 problem that they believe, at the time, is true, even though it may later turn out not to be.
- Creates an antitrust exemption for certain year-2000-preparation activities.

This bill may help high-technology entities to resolve some of the problems they are expected to experience on January 1, 2000. For a further discussion, see the section titled “The Year 2000 Issue” in the “Audit Issues and Developments” portion of this Audit Risk Alert.

## Audit Issues and Developments

### Going-Concern Issues

#### *Does the current industry and economic environment pose additional considerations regarding an entity's ability to continue as a going concern, and what impact will this have on audits of high-technology entities?*

.30 The high-technology industry exists in an environment typified by rapidly changing technologies (for example, product design and manufacturing processes), high levels of competition, large expenditures on research and development, and changing government regulations. This year, segments of the industry also had to deal with the crisis in Asia and product oversupply. Factors such as these may affect a high-technology entity's ability to continue as a going concern.

.31 Accordingly, auditors should be alert to conditions and events that, 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 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 substantial dependence on the success of a particular project; or (4) external matters, such as loss of a principal customer or supplier. 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.

.32 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). SAS No. 59 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.

.33 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 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.

.34 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.

#### **Executive Summary—Going-Concern Issues**

- Pursuant to SAS No. 59, when conducting an audit of financial statement in accordance with generally accepted auditing standards the auditor has a responsibility to evaluate whether there is a substantial doubt about the entity's ability to continue as a going-concern.
- Continuation of an entity as a going concern is assumed in the absence of significant information to the contrary.
- The economic and industry environment for high-technology entities may result in information about conditions or events that contradicts the going-concern assumption.
- SAS No. 59 provides guidance to the auditor with respect to making the above-mentioned evaluation.

### **The Crisis in Asia**

#### *Will the Asian crisis have an impact on high-technology audits this year?*

.35 The Asian crisis was one of the most significant economic developments in 1998, and there is continued speculation on how these developments will affect the U.S. economy. Many high-technology entities have been affected by the economic conditions in Asia. High-technology exports to countries in Asia are down significantly, although exports to the European Union, Canada, Mexico, and China have helped lessen the impact. Businesses dealing in computers, peripherals, and semiconductors, in particular, have typically had significant sales to Asia. In addition to the decreasing sales in Asia, the deep recessions plaguing a number of Asian countries pose a potential threat to continued growth in various segments of the global economy, including the U.S. This economic turmoil may result in broad concerns for auditors in general, and auditors of high-technology entities in particular. Some of these concerns are discussed here.

.36 As auditors consider the events and relate them to their audits of high-technology entities, they should be aware of their responsibilities pursuant to the guidance set forth in SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). SAS No. 22 requires, in part, that in planning the audit, the auditor should consider matters affecting the industry in which the entity operates, including current economic conditions. As such, auditors should assess the potential impact that the Asian crisis may have on their clients when considering the nature, extent, and timing of work to be performed. Factors to be considered in making the assessment might include whether Asian businesses are among the high-technology client's major customers or suppliers, the extent to which the client's products or services compete with low-priced Asian imports, or indirect effects, such as the extent to which a client's major customer is dependent on Asian trade.

.37 If it appears likely that the Asian crisis may have an impact on any aspect of the high-technology client's operations, consideration should be given to the possible audit and accounting issues that might arise. Examples could include some of the following:

- High-technology entities with significant export activities curtailed by the Asian crisis, such as some entities that sell PCs, may experience declines in the salability of their inventory and hence its valuation. Auditors should ensure that such inventories have been properly valued at the lower of historical cost (using an acceptable cost-flow assumption) or market.
- High-technology entities whose products compete with lower cost Asian products, such as some entities that sell semiconductors, may experience declines in the salability of their inventory and hence its valuation. Auditors should ensure that such inventories have been properly valued at the lower of historical cost (using an acceptable cost-flow assumption) or market.
- The economic crisis in Asia may affect the operations of entities in Asia that supply goods to the U.S., in a manner that results in a lowering of quality standards or delays in shipping. For example, high levels of exports from Asia may affect the ability to provide timely shipments if there is a shortage of shipping capacity. These types of situations could affect the quality of the client's inventory, commitments to customers, and so forth. Among the possible results is that disputes leading to legal action may arise with customers and suppliers over such matters. Information regarding such issues may point to the existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments, pursuant to SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).
- The collectibility of amounts due from troubled Asian entities or from entities with significant reliance on Asian trade may be called into question. Auditors should carefully consider whether management has properly assessed the collectibility of these receivables, as well as whether adequate consideration has been given to possible loan-impairment issues pursuant to FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan (an amendment to FASB Statements No. 5 and 15)* (FASB, *Current Text*, vol. 1, sec. I08).
- Going-concern issues may arise for high-technology entities with significant reliance on Asian trade or whose major customers have such reliance. In addition, entities whose products compete directly with less expensive Asian imports may also be at risk. In such circumstances, auditors should consider the guidance set forth under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.
- FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, requires that long-lived and certain identifiable intangible assets to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the assets' carrying amount may not be recoverable. For some entities, the Asian crisis may represent a significant adverse change in the business climate that indicates that the recoverability of the carrying amount of an asset should be assessed. Auditors should evaluate management's consideration of FASB Statement No. 121 issues for assets that are directly or indirectly affected by the Asian crisis.
- The appropriate classification of investments in debt and equity securities of Asian entities, or entities with material dealings with Asian entities accounted for under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text*, vol. 1, sec. I80), could be an area of increased audit risk. There may be a greater risk of inappropriate classification of such securities as available-for-sale rather than as trading securities, so that any unrealized losses are reported in other comprehensive income rather than in current earnings. SAS No. 81, *Auditing Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides auditing guidance for investments accounted for under FASB Statement No. 115, as well as Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (FASB, *Current Text*, vol. 1, sec. I82).

- Greater risk may be associated with entities involved in Asian foreign-currency-related transactions. Auditors should consider whether management has appropriately accounted for, and made all required disclosures relating to, foreign-currency translation and transactions arising from the translation of asset and liability positions and revenue and expense transactions in currencies other than the U.S. dollar pursuant to FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60).
- For some clients, the economic impact of the Asian crisis may engender fraud risk factors that suggest an increased possibility of misstatements arising from fraudulent financial reporting. For example, to offset losses incurred from a slowdown in sales to Asian customers, an entity may resort to the inappropriate acceleration of revenue recognition or the improper deferral of expenses. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316) sets forth the auditor's responsibilities concerning fraud in a financial statement audit.
- The Asian crisis is likely to result in more risks and uncertainties for many entities, particularly with regard to current vulnerability due to certain concentrations. Auditors should consider whether management has appropriately evaluated all such risks and uncertainties and made the necessary disclosures pursuant to SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition, auditors should also evaluate management's consideration of related contingencies arising from the Asian crisis, pursuant to FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59).

These examples call attention to some of the possible auditing and accounting implications of the Asian crisis, but should not be viewed as an exhaustive list of all the issues that might arise. Auditors of high-technology entities should continue to monitor the crisis and assess its impact on their clients by considering all relevant facts and circumstances.

#### Executive Summary—The Crisis in Asia

- The deep recessions plaguing a number of Asian countries (commonly referred to as the Asian crisis) pose a potential threat to continued growth in various segments of the global economy, including the U.S.
- Auditors should assess the potential impact that the Asian crisis may have on their high-technology clients when considering the nature, extent, and timing of work to be performed.
- Auditors should consider the possible audit and accounting issues that might arise as a result of the Asian crisis, including going concern, valuation, impairment, collectibility, and fraud.

### Risk of Material Misstatement Due to Fraud

#### *Why is the risk of client fraud of particular concern to auditors of high-technology entities?*

.38 As a general rule, technology is a high-profile industry. A significant amount of business news coverage is devoted to this industry, and changes in the share prices of the technology group of stocks are often a matter of general business interest. It is also seen as a growth industry and expected to grow at rates in excess of more mature industries. The continual scrutiny and the pressure to meet market expectations is one factor that may lead to additional concerns on the part of the auditor that there has been no material misstatement of earnings.

.39 Failing to meet market expectations can have a significant effect on the value of the company's stock and the value of employee stock options, which are often a significant portion of total management compensation in high-technology entities. Even minimal changes in share price can affect perceptions of how well the company's products are accepted by consumers and affect consumer decisions about continuing to buy products based on the company's technology. Entities that are considering merger activity, which is common in the high-technology industry, may also be concerned about reported earnings. Entities that may be potentially acquiring another entity or that are potential targets of an acquisition may be concerned about

reporting expected earnings in a way that does not negatively affect potential acquisition plans. Additionally, some high-technology entities have earnings pressures resulting from poor sales, declining margins, increased competition, turbulent overseas economies, and so forth. Notice that many of the issues discussed above are not related to poor earnings, merely earnings not in line with expectations.

.40 Among its provisions, SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, provides categories of fraud risk factors that the auditor should consider in assessing the risk of material misstatement due to fraud. Shown here are a few of the many possible risk factors in SAS No. 82 that may be of significance to a particular high-technology audit client:

- 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
- 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
- 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
- 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
- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity
- High degree of competition or market saturation, accompanied by declining margins
- Rapid changes in the industry, such as high vulnerability to rapidly changing technology or rapid product obsolescence
- 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
- Significant, unusual, or highly complex transactions, especially those close to year end, that pose difficult "substance over form" questions
- Unusually rapid growth or profitability, especially compared with that of other companies in the same industry
- Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported
- Inventory characteristics, such as small size, high value, or high demand

.41 In an effort to assist auditors in the understanding of SAS No. 82, the AICPA has developed the following materials:

- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883). This AICPA publication provides nonauthoritative guidance to practitioners on considering fraud in financial statement audits. This publication provides implementation guidance, industry-specific risk factors (along with suggested audit responses) and various practice aids (audit procedures, sample workpaper documentation, and engagement and representation letters).
- *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities Under SAS No. 82*. This continuing professional education course is available in a text version (Product No. 732046) and a CD-ROM version (Product No. 738080).

**Executive Summary—Risk of Material Misstatement Due to Fraud**

- The high-profile nature of the technology industry and the expectations of high growth may result in additional pressure on high-technology entities to meet market expectations and additional concerns on the part of the auditor regarding material misstatement of earnings.
- Auditors should be familiar with the requirements of the new fraud standard, SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, which provides, among other things, that auditors specifically assess the risk of material misstatement due to fraud in every audit.
- SAS No. 82 provides examples of fraud risk factors to assist the auditor in making this assessment.
- The AICPA has produced various materials to assist the auditor in understanding SAS No. 82.

**Business Combinations***How does the trend toward merger and consolidation in the high-technology industry affect auditors of high-technology entities?*

.42 There has been significant merger activity in the high-technology industry recently, as entities attempt to increase market share, gain access to new markets, or acquire the knowledge of the infrastructure to keep competitive. In particular, there have been some high-profile mergers in the telecommunications and the Internet industry segments. As a result, auditors of high technology entities face a greater likelihood of dealing with clients that were involved in a business combination in the last year and with clients facing an upcoming business combination. The following is a discussion of some of the issues relating to business combinations that the auditor may be facing.

.43 A business combination, according to APB Opinion 16, *Business Combinations* (FASB, *Current Text*, vol. 1, sec. B50), occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity that results carries on the activities of the previously separate, independent enterprises. The auditing and accounting issues that arise out of corporate consolidations are numerous and varied. Auditors should carefully consider the individual circumstances of the client to identify those issues and to then develop an appropriate audit strategy. Examples of some of the issues that should be considered by auditors include the following:

- Careful consideration should be given to management's accounting for the business combination to ensure that all relevant generally accepted accounting principles (GAAP) have been considered, and for publicly-held entities, all relevant SEC rules and regulations should be considered also. For example, if the pooling-of-interests method has been used, have the specific criteria of APB Opinion 16 been met?<sup>2</sup> If not, has the purchase price been allocated to the assets (including identifiable intangibles) and liabilities acquired with goodwill properly calculated in accordance with the purchase method of accounting?
- If specialists have been used in asset or liability valuation, auditors relying on such information should understand their responsibilities when using the work of a specialist, as set forth under SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).
- The question of the valuation and the subsequent write-off of in-process research and development have been an area of particular concern for the SEC recently, particularly with respect to high-technology companies. Accordingly, audit risk in this area may be especially acute for publicly-held high-technology

<sup>2</sup> Accountants, other than the continuing accountant, who have been requested to provide advice on the application of accounting principles to specified transactions, such as whether a proposed business combination is in compliance with the pooling requirements of APB Opinion 16 and other related GAAP, should refer to the guidance set forth under SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625).

entities. See the section titled "In-Process Research and Development in a Purchase Business Combination" in the "Accounting Issues and Developments" portion of this Audit Risk Alert.

- Auditors should also be alert to consensus positions reached this year by the FASB's EITF relating to business combinations. See the "EITF Consensus Positions" section of the publication *Audit Risk Alert—1998/99* [AAM section 8010]<sup>3</sup> for more information.
- With consolidation comes dramatic change in the structure of an entity. In an effort to create greater cost efficiencies in the consolidated entity, departments may be combined and duplicative functions eliminated. Auditors should consider the impact of such changes on their client's internal control when making the assessment of control risk. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit, An Amendment to Statement on Auditing Standards No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).
- Business combinations often result in the gain of a client for one auditor and a loss of a client for another. Thus, in the current environment, auditors may be more likely to find themselves in the role of either a predecessor or successor auditor. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place.
- Mergers and acquisitions may be effected in part through the use of debt financing. Auditors should carefully evaluate the terms of the debt agreement to identify, among other things, whether there are any loan covenants, and if so, the terms. Auditors should evaluate compliance with restrictive covenants and the implications of any loan covenant violations.
- The acquisition of an entity by one party may mean that another party has disposed of a business segment. Accordingly, auditors of the selling party should consider whether management has followed the accounting and disclosure requirements of APB Opinion 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* (FASB, *Current Text*, vol. 1, sec. I13). Audit risk may be significant for discontinued operations involving an extended phase-out period. Auditors should give careful consideration to management's estimates when the disposal date of the segment occurs after year end. SAS No. 57, *Auditing Accounting Estimates*, provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.
- Subsequent to the business combination, auditors should consider whether management has prepared the financial statements of the combined entity in accordance with appropriate accounting standards, including 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)* (FASB, *Current Text*, vol. 1, sec. C51) and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements* (FASB, *Current Text*, vol. 1, sec. C51).
- A business combination involving a public business enterprise may result in an operating segment subject to the disclosure requirements of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30). In such circumstances, auditors should consider the guidance set forth under auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326).

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<sup>3</sup> The *Audit Risk Alert—1998/99* [AAM section 8010] provides a general update on economic, auditing, and accounting matters.

**Executive Summary—Business Combinations**

- The ongoing consolidations of high-technology entities suggest that auditors are more likely to face the numerous and varied issues relating to business combinations.
- Auditors should carefully consider the individual circumstances of the client to identify the auditing and accounting issues that arise out of corporate consolidations.
- Auditors should consider the possible auditing and accounting issues that might arise as a result of a business combination, including the accounting methods used, effects on internal control, predecessor and successor communications, and discontinued operations.

**SEC Concerns Regarding Disclosures About Restructuring Charges and Liabilities Recognized in Connection with Purchase Business Combinations**

*What are some of the auditing and accounting issues of concern to the SEC regarding disclosures about restructuring charges and liabilities recognized in connection with purchase business combinations?*

.44 During informal discussions with representatives of the AICPA, the SEC staff have expressed concerns with regard to certain recurring auditing and accounting issues that they have encountered. One issue that may be of particular interest to auditors of high-technology entities is that of disclosures about restructuring charges and liabilities recognized in connection with purchase business combinations. (Additional issues are covered in the publication *Audit Risk Alert—1998/99* [AAM section 8010]. Auditors of entities subject to the SEC reporting requirements may wish to consider these issues.)

.45 When liabilities are accrued in accordance with the guidance in EITF Issue Nos. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, and 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*, certain disclosures are required. The thresholds for making the required disclosures are related to the materiality of the amounts accrued or the significance of the activities that will not be continued. Therefore, when the disclosure thresholds have been met, all the disclosures are required, not just those that are individually material.

.46 Some of the disclosures are required until the plan of termination is completed or until all actions under a plan to exit an activity or involuntarily terminate employees of an acquired company have been fully executed. For instance, under EITF Issue No. 94-3, the amount of actual termination benefits paid and charged against the liability and the number of employees actually terminated as a result of the plan to terminate the employees must be disclosed. The amount of any adjustments to the liability also must be disclosed.

.47 The SEC staff have observed an increasing frequency of subsequent reductions to restructuring liabilities, which suggests that management may be “providing a cushion” in establishing such reserves. When reviewing management’s accruals, auditors should be aware of the kinds of charges that are allowed to be accrued for pursuant to EITF Issue Nos. 94-3 and 95-3 (and other relevant accounting literature, as appropriate), and be mindful that management’s estimates are not overly conservative.

.48 Additionally, the SEC staff have stated that liabilities accrued in accordance with EITF Issue Nos. 94-3 and 95-3 are valuation accounts that should be disclosed on Schedule VIII, Valuation and Qualifying Accounts, of SEC registrants’ annual reports filed on Form 10-K.

.49 SEC Chairman Levitt’s comments on this and other issues are contained in a recent speech titled *The Numbers Game*, which is available on the SEC Web site at [www.sec.gov](http://www.sec.gov).

.50 Also, the SEC staff is expected to issue a Staff Accounting Bulletin (SAB) on asset impairment and restructuring charges. Other SABs are expected on materiality and revenue recognition.

## Inventory Valuation

*How does the issue of inventory valuation affect auditors of high-technology audit clients?*

.51 The primary literature on inventory accounting is ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapters 3A and 4 (FASB, *Current Text*, vol. 1, sec. I78), which provides the following summary:

Inventory shall be stated at the lower of cost or market except in certain exceptional cases when it may be stated above cost. *Cost* is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in, first-out; average; and last-in, first-out).

.52 Whether inventory is properly stated at lower of cost or market can be a very significant issue for high-technology audit clients because of rapid changes that can occur in many areas, and the need for entities to keep up with the newest technology. Examples of factors that may affect inventory pricing include the following:

- Changes in a products' design may have an adverse impact on the entity's older products, with older products not as salable as the newer versions.
- A competitor's introduction of a technologically advanced version of the product may decrease salability of a client's products.
- Changes in the products promoted by the industry as a whole, such as a shift from analog to digital, may affect salability.
- Changes in foreign economies that result in such situations as slowdown of sales to that region or lower-priced imports from that region, as with Asia.
- Changes in the technology to produce high-technology products can give competitors a selling-price advantage.
- Changes in regulations, such as the Telecommunications Act of 1996, could affect the competitive environment.
- The entity's own product changes may not be well researched due to the pressure to introduce new products quickly, resulting in poor sales or high returns.

.53 The highly competitive environment and the rapid advancement of technological factors contribute to the common problem of rapid inventory obsolescence in the high-technology industry. As such, auditors should consider whether the value at which inventories are carried is appropriate.

.54 The auditor may look at many factors in determining the proper valuation of inventories. A few examples of those factors that may be useful include the following:

- Product sales trends and expected future demand
- Sales forecasts prepared by management as compared with industry statistics
- Anticipated technological advancements that could render existing inventories obsolete or significantly reduce their value
- Inventory valuation ratios, such as gross profit ratios, inventory turnover, obsolescence reserves as a percentage of inventory, and days sales in inventory
- New product lines planned by management and their effects on current inventory



- New product announcements by competitors
- Economic conditions in markets where the product is sold
- Economic conditions in areas where competitive products are produced
- Changes in the regulatory environment
- Unusual or unexpected movements, or lack thereof, of certain raw materials for use in work-in-process inventory
- Levels of product returns
- Pricing trends for the type of products sold by the client
- Changes in standards used by the industry

.55 Also, the auditor may need to address many other issues, including the taking of physical inventories in high-technology entities. The auditor should consider the guidance set forth in SAS No. 1, section 331, as amended, *Inventories* (AICPA, *Professional Standards*, vol. 1, AU sec. 331). Among the issues for the auditor's consideration are the following:

- When dealing with some difficult types of inventory, such as chemicals used in processing, the auditor may need to take samples for outside analysis. The work of a specialist may also be needed, and the auditor should follow the guidance set forth in SAS No. 73, *Using the Work of a Specialist*.
- The extent to which raw material have been converted to work-in-process will need to be determined to access the value of the work-in-process.
- Indications of old or neglected materials or finished goods need to be considered in the valuation of the inventory.
- The client's inventory held by others will need to be considered, as well as field service inventories for use in servicing the client's products.

#### Executive Summary—Inventory Valuation

- Inventory valuation is a significant issue for auditors of high-technology audit clients, primarily due to the rapid rate of inventory obsolescence in this industry.
- Auditors need to be alert to potential threats to the salability of inventory, such as changes in technology or new competitors in the field with more advanced products.
- Observing the physical inventory process may require use of specialists.

## Illegal Acts

*What types of illegal acts should the auditor be aware of in the high-technology industry?*

.56 As with all businesses, entities in the high-technology industry are subject to numerous laws and regulations relating to such matters as environmental protection, equal employment, and price-fixing or other antitrust violations. This last area has received much media coverage recently, and should serve as a reminder to auditors of their responsibilities with respect to illegal acts by clients.

.57 An auditor's responsibility under GAAS is explained in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). The term *illegal acts* as used in that SAS refers to violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial state-

ments are under audit or acts by management or employees acting on behalf of the entity. Illegal acts by clients do not include personal misconduct by the entity's personnel unrelated to their business activities.

.58 Although the auditor may recognize that some client acts coming to the auditor's attention may be illegal, the determination as to whether a particular act is illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

.59 The SAS explains that the auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud as described in footnote 1 in AU section 110.02, *Responsibilities and Functions of the Independent Auditor*.

.60 With respect to other illegal acts, SAS No. 54 provides, in part:

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. 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. For example, securities may be purchased or sold based on inside information. While the direct effects of the purchase or sale may be recorded appropriately, their indirect effect, the possible contingent liability for violating securities laws, may not be appropriately disclosed. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

.61 The illegal acts described in the excerpt above may, in particular circumstances, be regarded as having material but indirect effects on financial statements. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. However, because of the characteristics of illegal acts described in the excerpt above, an audit performed in accordance with GAAS provides no assurance that these illegal acts will be detected.

.62 SAS No. 54 provides guidance with respect to various issues, including the following:

- Audit procedures in the absence of evidence concerning possible illegal acts
- Specific information concerning possible illegal acts
- Audit procedures in response to possible illegal acts
- The auditor's response to detected illegal acts, including consideration of the financial statement effect, implications for the audit, communication with the audit committee, and the effect on the auditor's report
- Circumstances in which the auditor may have a duty to notify parties outside the client

.63 Additionally, auditors 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) to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

## The Year 2000 Issue

*What is the Year 2000 Issue and how does it affect high-technology audit clients and their auditors?*

.64 The Year 2000 Issue relates to the inability of many electronic data processing (EDP) systems to accurately process year-date data beyond the year 1999. This is attributable to the fact that the majority of computer programs in use today were designed to store dates in the date/month/year (dd/mm/yy) format, thus allowing only two digits for each date component. So, for example, the date December 31, 1998, is stored in most computers as 12/31/98. Inherent in programming for dates in this manner is the assumption that the designation 98 refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit-year input fields will cause many computers to treat the entry 00 as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00), as January 1, 1900, and process data incorrectly, or perhaps not at all.

.65 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year 2000 ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur this year. For example, some software programs may have assigned special meanings to entries date coded as xx/xx/98 or xx/xx/99 to allow for the testing of software modifications. Therefore, actual transactions using such dates may not be processed correctly or stop functioning. Failures may also take place currently when systems perform calculations into or beyond the year 2000.

.66 Unless these year 2000 problems are remedied, significant problems relating to the integrity of all electronically processed information based on time will occur. For example, since many types of computer programs use dates as part of the program, program results could be affected. Inventory control systems might treat new items as obsolete, receivables may be erroneously classified as past due, computerized equipment maintenance schedules could be affected, and so on. The problem affects not only computers and software, but also such items as electronic devices and equipment with imbedded computer chips that are date sensitive. Any systems that use date information, such as card-entry systems, can be affected.

.67 Even when the entity's computer software and hardware are year 2000 ready, the entity may be affected by the computer systems of distributors, suppliers, customers, third-party data-processing services, and other organizations with which the client interacts, when they have made no such modifications. For example, telecommunication carriers need to be concerned about how their networks interface with end-user systems, other carriers, and information and enhanced service providers. (See the FCC Web site at <http://www.fcc.gov> for information on some activities of the telecommunications segment regarding the Year 2000 Issue.)

.68 The significance of these issues to high-technology clients is multi-faceted. Four of the broad ramifications are: (1) if the year 2000 problem is not remedied, it may affect the integrity of systems and information used by the high-technology client; (2) if the year 2000 problem is not remedied, it may affect customers of the high-technology client who have purchased non-year 2000 ready hardware and software products from the client; (3) if not remedied, it could affect the ability of the high-technology company to meet commitments to provide products and services, due to such factors as production or shipping problems; and (4) the year 2000 problem may provide opportunities for high-technology clients to provide solutions to this problem.

.69 Clearly, the Year 2000 Issue has the potential to adversely affect the operations of entities that rely, directly or indirectly, on information technology. What, however, are the auditor's responsibilities for the Year 2000 Issue?

.70 First, it must be understood that it is the responsibility of an entity's management to assess and remediate the effects of the Year 2000 Issue on an entity's systems—not the auditor's. The Year 2000 Issue does not create additional responsibilities for the auditor. Under GAAS, 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Year 2000 Issue or by some other cause.

.71 However, auditors should be aware of the many auditing and accounting issues that arise from the Year 2000 Issue, including audit planning and supervision, going-concern issues, and establishing an understanding with the client. A more comprehensive discussion of these issues, including information on new AICPA pronouncements, is included in the publication *Audit Risk Alert—1998/99* [AAM section 8010]. However, some items that may be of particular interest to auditors of high-technology entities are highlighted here.

- Revenue recognition principles for software transactions are set forth in AICPA SOP 97-2, *Software Revenue Recognition*. This SOP provides guidance on the amount and timing of revenue recognition in arrangements that may include the presence of specific factors, including uncertainty of customer acceptance; customer cancellation privileges; and multiple elements, including upgrades and enhancements and postcontract customer support. Entities should be aware that the Year 2000 Issue could affect one or more of these factors and have an unexpected effect on future revenue recognition. See a further discussion titled "Revenue Recognition" in the "Accounting Issues and Developments" portion of this Audit Risk Alert. Among the issues addressed in that section are the applicability of SOP 97-2 (it is also applicable to entities other than traditional software providers) and that SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2*, Software Revenue Recognition, delayed the effective date of a provision of SOP 97-2.
- The Year 2000 Issue may create product warranty and product defect liability and product returns issues for software and hardware vendors. These vendors should consider FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 24 to 26, if there are product warranty or product defect liability issues and FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, for product return issues.
- Software developers should evaluate arrangements to address the Year 2000 Issue performed for other entities for a fee that are being accounted for under SOP 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts*. For any contract expected to result in a loss, the vendor should record a provision for the entire loss in the period in which it becomes evident.
- FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* (FASB, *Current Text*, vol. 2, sec. Co2), is the authoritative standard on accounting for costs incurred to produce or purchase software that is to be sold, leased, or otherwise marketed. Only certain costs qualify for capitalization under this standard. In accordance with the guidance in the Statement, a write-down or an acceleration of amortization may be necessary if estimated future gross sales are lower than expected because of the Year 2000 Issue.
- Inventories of hardware devices that are not year 2000 ready would be subject to the lower of cost or market test described in ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 4, paragraph 8 (FASB, *Current Text*, vol. 1, sec. I78).
- High-technology entities that have sold hardware or software, or provided installation or consulting services, may be at risk for legal action from customers who believe the responsibility for resulting problems lies with the client. The auditor should consider this when performing procedures pursuant to SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*.
- High-technology clients that are successfully addressing the Year 2000 Issue with products and services, such as hardware, software, consulting, and installation, may see revenue increases in a manner that will not continue into the future. The auditor should be aware that management may be making overly optimistic growth projections that could affect its decisions, such as financing decisions, and these projections may find their way into management's discussion and analysis (MD&A). Two new pronouncements issued this year discuss particular services on management's discussion and analysis. Statement on Standards for Attestation Engagements (SSAE) No. 8, *Manage-*

ment's Discussion and Analysis (AICPA, Professional Standards, vol. 1, AT sec. 700) and SAS No. 86, Amendment to SAS No. 72, Letters for Underwriters and Certain Other Requesting Parties (AICPA, Professional Standards, vol. 1, AU sec. 634). Further information on these pronouncements is included in the "New Auditing and Attestation Pronouncements" portion of this Audit Risk Alert.

- In addition to the disclosure requirements under the pronouncements previously mentioned, practitioners should be aware of the requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Although the need for disclosure by an entity depends on facts and circumstances, disclosure may be required in such areas as impairment or amortization of capitalized software costs, inventory valuation, long-term contract accounting, or litigation, if it is reasonably possible that the amounts reported in the financial statements could change by a material amount within one year from the date of the financial statements. Disclosures also may be required of current vulnerability due to certain concentrations if, for example, a significant vendor has not satisfactorily addressed the Year 2000 Issue.
- Auditors of publicly held companies should consider the guidance set forth by the SEC in its Interpretation titled "Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers," (the Interpretation). The Interpretation supersedes the guidance previously set forth in the revised Staff Legal Bulletin No. 5. The full text of the Interpretation can be viewed on the SEC Web site, <http://www.sec.gov>.

.72 Auditors should also be aware of the risk of litigation relating to the Year 2000 Issue. Some clients may be uninformed about it, while others may underestimate its magnitude. Those who mistakenly believe that the Year 2000 Issue should be addressed and resolved as part of the audit process may seek legal recourse if that outcome is not achieved. Therefore, auditors may wish to educate their clients on the Year 2000 Issue and its implications and incorporate these issues in the engagement letter by outlining the responsibilities of both the client and the auditor.

.73 A more complete discussion of the implications of the Year 2000 Issue, along with a list of published guidance in this area, can be found in the *Audit Risk Alert—1998/99* [AAM section 8010]. Also the AICPA's Web site, <http://www.aicpa.org>, provides a year 2000 resource page with additional information and links with other sites, and the AICPA publication "The Year 2000 Issue—Current Accounting and Auditing Guidance."<sup>4</sup>

#### Executive Summary—The Year 2000 Issue

- Unless corrective actions are taken, the Year 2000 Issue may cause accounting and financial information systems to produce inaccurate date-related output.
- Among the issues that may be of particular interest for auditors of high-technology entities are how the Year 2000 Issue can affect software revenue recognition, product warranties and product returns, software development arrangements, accounting for costs of software that is to be sold, leased, or otherwise marketed, inventory valuation, entity growth projection, and potential litigation.
- Auditors should consider client accounting for the Year 2000 Issue pursuant to applicable accounting pronouncements. For publicly held entities, SEC rules and regulations should be considered.
- Additional information on accounting and auditing pronouncements related to the Year 2000 Issue and how the Year 2000 Issue can affect entities and their auditors, can be found in the publication *Audit Risk Alert—1998/99* [AAM section 8010].

<sup>4</sup> With regard to this publication, the SEC Interpretation on year 2000 issues (referred to above) states that "Although the term 'may' is used throughout the AICPA's guidance, perhaps suggesting that the guidance is discretionary, we believe that the procedures outlined by the AICPA should be considered appropriate practice at this time and we expect companies and their auditors to comply with that guidance. If they do not, they should be prepared to justify why the procedures were not followed."

## New Auditing and Attestation Pronouncements

*What new auditing and attestation pronouncements have been issued this year?*

### New Auditing Standards

#### SAS No. 86

.74 SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634) was issued in March 1998 by the ASB to reflect the issuance of SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners that have examined or reviewed MD&A in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

#### SAS No. 87

.75 SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), was issued in September 1998 by the ASB and is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The SAS states that an auditor should restrict the use of a report if the following occur.

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

.76 In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used in restricted-use reports, and requires an auditor to restrict a single combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

#### SAS No. 21—Rescinded

.77 SAS No. 21, *Segment Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 435) contained guidance for auditing disclosures made in accordance with the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 was superseded upon the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30), which is effective for fiscal years beginning after December 15, 1997, with earlier application encouraged. Accordingly, the ASB has rescinded SAS No. 21 effective for audits of financial statements to which FASB Statement No. 131 has been applied. In its place, Auditing Interpretation No. 4 of SAS No. 31, *Evidential Matter, "Applying Auditing Procedures to Segment*

Disclosures in Financial Statements,” has been issued. See the “New Auditing Interpretations” section of *Audit Risk Alert—1998/99* [AAM section 8010] for a more detailed discussion of the new Interpretation.

.78 The following ASB pronouncements became effective during 1998:

- SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310) (effective for engagements for periods ending on or after June 15, 1998)
- SAS No. 84, *Communications Between Predecessor and Successor Auditors* (effective for engagements accepted after March 31, 1998)
- SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333) (effective for audits of financial statements for periods ending on or after June 30, 1998)
- SSAE No. 7, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AT sec. 100) (effective for engagements for periods ending on or after June 15, 1998)

## New Attestation Standard

### SSAE No. 8

.79 Issued by the ASB in March 1998, SSAE No. 8, *Management’s Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700), provides guidance to a practitioner on the performance of a review or examination of MD&A prepared pursuant to the rules and regulations of the SEC. The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8 provides the following:

- Conditions for engagement performance for both examinations and reviews of MD&A
- Extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A
- A comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8

SSAE No. 8 became effective upon issuance.

.80 In September 1998, the ASB voted to issue the exposure draft *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity’s Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation* as a final standard. See the “Exposure Draft Issued by the Auditing Standards Board ” section of the publication *Audit Risk Alert—1998/99* [AAM section 8010] for further information.

## New Auditing Interpretations, a New Attestation Interpretation, and New AITF Advisories

.81 The following is a list of recently issued auditing Interpretations, attest Interpretations, and AITF Advisories. Summaries of the interpretations and advisories can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

### New Auditing Interpretations

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- Interpretation No. 4, “Audit Considerations for the Year 2000 Issue,” of AU Section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311)
- Interpretation No. 1, “The Use of Legal Interpretations as Evidential Matter to Support Management’s Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of

Financial Accounting Standards Board Statement No. 125," of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336)

- Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324)
- Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341)
- Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326)
- Interpretation No. 3, "Commenting in a Comfort Letter on Quantitative and Qualitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K," of SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9634)

### ***New Attestation Interpretation***

.83 Interpretation No. 1, "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis," of SSAE No. 8, *Management's Discussion and Analysis*.

### ***New Audit Issues Task Force Advisories<sup>5</sup>***

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- AITF Advisory Concerning Comprehensive Income
- AITF Advisory Concerning Practice Issues Regarding Language to Permit the Use of Legal Opinions by Auditors (Note that this Advisory was an intermediary document. It was replaced by the amended Interpretation to SAS No. 73, included in the preceding list under the heading "New Auditing Interpretations.")

.85 A list of the Statements of Position issued this year are included in the section titled "New AICPA Accounting and Auditing Statements of Position" in this Audit Risk Alert.

## **Accounting Issues and Developments**

### **Revenue Recognition**

*What significant factors should the auditor consider with respect to revenue recognition for high-technology audit clients?*

.86 One significant factor that complicates revenue recognition in the high-technology industry is that there are many individualized agreements, often with unusual or complex terms. Because a type of technology can often be used in many ways in different types of products without incurring significant additional costs, a vendor may fashion individual products and services for different clients. They can provide for extended payment terms, the right to receive future products or services, cancellation options, rights of returns, rights of exchange, acceptance clauses, free services, price protection, and so forth. In addition, even the standard sales contract may have features that make revenue recognition less than straightforward, such as requiring substantial continuing vendor involvement after delivery of merchandise

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<sup>5</sup> From time to time the AITF issues AITF Advisories to provide nonauthoritative guidance on current developments or recently issued authoritative literature.



(for example, software or hardware sales requiring installation, debugging, extensive modifications, or other significant support commitments). These types of issues make the determination of proper revenue recognition more difficult in the high-technology industry than in many other industries.

.87 Additionally, the issue of improper revenue recognition has been reported in the media lately. A discussion of this issue is included in the section titled “Improper Revenue Recognition” in the “Current Audit Issues” portion of the publication *Audit Risk Alert—1998/99* [AAM section 8010]. The AICPA staff, with the oversight of AICPA technical committees, is preparing a nonauthoritative “toolkit” to help financial statement preparers and auditors better understand issues surrounding revenue recognition, and the AICPA SEC Practice Section Professional Issues Task Force is preparing a Practice Alert, *Revenue Recognition Issues*. These two publications will be available on the AICPA Web site by the end of 1998.

.88 In dealing with complex revenue recognition questions that are not directly addressed in the accounting literature, it may be useful to understand the principles set forth in the FASB’s Statements of Financial Accounting Concepts. For example, Concept Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, includes a list of fundamental recognition criteria. Guidance of a more specific nature may be found in FASB and AICPA accounting pronouncements, such as those discussed in the following sections, and, for SEC registrants, literature such as the SEC’s Accounting and Auditing Enforcement Releases (for example, Release No. 108, which addresses bill and hold situations). Some accounting pronouncements that may be of significance to high-technology audit clients are discussed below.

.89 SOP 97-2, *Software Revenue Recognition* (See the next two headings for sections on SOP 98-4, regarding deferral of a provision of 97-2, and on an exposure draft addressing this issue.)

.90 In October 1997, the Accounting Standards Executive Committee (AcSEC), issued SOP 97-2, *Software Revenue Recognition*. This SOP provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. This SOP supersedes SOP 91-1, *Software Revenue Recognition*. This SOP requires the following:

- 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.
  - Persuasive evidence of an arrangement exists.
  - Delivery has occurred.
  - The vendor’s fee is fixed or determinable.
  - Collectibility is probable.
- Software arrangements may consist of multiple elements, that is, additional software products, upgrades/enhancements, 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, services that do not involve significant customization, subscriptions, and arrangements in which the fee is based on the number of copies.
- Vendor-specific objective evidence of fair value is limited to (a) the price charged when the element is sold separately, or (b) if the element is not yet being sold separately, the price for each element established by management having the relevant authority.

- The portion of the fee allocated to an element should be recognized as revenue when all of the revenue recognition criteria have been met. In applying those criteria, the 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, the collectibility of that portion of the fee is not considered probable if the amount of the fees allocable to delivered elements is subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.
- Separate accounting for a service element of an arrangement is required if both of the following criteria are met.
  - The services are not essential to the functionality of any other element of the transaction.
  - The services are described 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.
- 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 (ARB) 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 criteria specified in SOP 97-2 for separate accounting for any service element are met.

This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

.91 Auditors should be aware this SOP is applicable to entities other than traditional software companies. The "Scope" section of the SOP provides, in part—

This SOP provides guidance on when revenue should be recognized and in what amounts for **licensing** [defined in the glossary], selling, leasing, or otherwise marketing computer software. It should be applied to those activities by all entities that earn such revenue. It does not apply, however, to revenue earned on products or services containing software that is incidental<sup>2</sup> to the products or services as a whole.

<sup>2</sup> Indicators of whether software is incidental to a product as a whole include (but are not limited to) (a) whether the software is a significant focus of the marketing effort or is sold separately, (b) whether the vendor is providing postcontract customer support, and (c) whether the vendor incurs significant costs that are within the scope of FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*. An example of the applicability of this SOP to revenue earned on products containing software is included in appendix A, "Examples of the Application of Certain Provisions of This Statement of Position."

.92 SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition* (See the next section regarding an exposure draft addressing this issue.)

.93 In March 1998, AcSEC issued SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*. This SOP defers for one year the application of the following passages in SOP 97-2, which limit what is considered vendor-specific objective evidence of the fair value of the various elements in a multiple-element arrangement:

- (1) The second sentences of paragraphs 10, 37, 41, and 57
- (2) Example 3 in "Multiple-Element Arrangements—Products" on page 67 (appendix A)

(3) Example 3 in “Multiple-Element Arrangement—Products and Services” on page 70 (appendix A)

All other provisions of SOP 97-2 remain in effect.

.94 This SOP applies to all multiple-element software arrangements, as defined in paragraph 9 of SOP 97-2, and is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated.

***Exposure Draft of a Proposed SOP, “Modification of the Limitations on Evidence of Fair Value in Software Arrangements”***

.95 In July 1998, AcSEC issued an exposure draft of a proposed SOP, *Modification of the Limitations on Evidence of Fair Value in Software Arrangements*. This exposure draft proposed rescinding the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2, *Software Revenue Recognition*, which limit what is considered vendor-specific objective evidence of fair value of the various elements in a multiple-element arrangement. It also proposed amending certain examples in SOP 97-2 that are affected by the rescinded sentences and adding an additional example. Comments on the exposure draft were due by September 30, 1998.

.96 After considering the comment letters on the exposure draft, AcSEC decided not to rescind the second sentences of paragraphs 10, 37, 41, and 57 of SOP 97-2, as had been proposed. Instead, AcSEC approved, *subject to FASB clearance*, issuance of an SOP that would amend SOP 97-2 to provide for revenue recognition under the “residual” method when (a) there is vendor-specific objective evidence of the fair value of *all* undelivered elements in a multiple-element arrangement that is not accounted for using long-term contract accounting, (b) vendor-specific objective evidence does not exist for one or more of the delivered elements in the arrangement, and (c) all revenue recognition criteria in SOP 97-2 other than the requirement for vendor-specific objective evidence of the fair value of each element are satisfied.

.97 Under the residual method, the arrangement fee is recognized as follows: (a) the total fair value of the undelivered elements is deferred and subsequently recognized in accordance with the relevant sections of SOP 97-2, and (b) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

.98 The proposed SOP would be effective for transactions entered into in fiscal years beginning after March 15, 1999, with earlier adoption permitted as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the SOP would be prohibited.

.99 Auditors should consult the final SOP to determine the final provisions of this pronouncement.

***FASB Statement No. 48, Revenue Recognition When Right of Return Exists***

.100 As with most entities that sell products, customers of these entities often have certain return rights. FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (FASB, *Current Text*, vol. 1, sec. R75), specifies criteria for recognizing revenue on a sale in which a product may be returned, whether as a matter of contract or as a matter of existing practice, either by the ultimate customer or by a party who resells the product to others. FASB Statement No. 48 provides that revenue from such sales transactions shall be recognized at the time of sale only if all 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.<sup>6</sup>
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<sup>7</sup> can be reasonably estimated.

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.

.101 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 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

.102 In circumstances where the right of return exists, the auditor should assess the client's application of FASB Statement No. 48 by referring to the full text of the statement.

.103 Additionally, paragraphs 35 through 55 of SOP 97-2 provide additional guidance regarding the application of FASB Statement No. 48 to sales of software.

.104 For publicly held entities, 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.

### **FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts**

.105 The high-technology entity may also have revenue from the sale of separately priced extended warranty and product maintenance contracts to customers. Auditors should distinguish between separately priced extended warranty and product maintenance contracts covered under FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (FASB, *Current Text*, vol. 1, sec. R75) and postcontract customer support (PCS) covered under SOP 97-2, *Software Revenue Recognition*. A typical PCS arrangement might include services such as telephone support and correction of errors (bug fixing or debugging). FASB Technical Bulletin No. 90-1 addresses how revenue and costs from a separately priced extended warranty or product maintenance contract should be recognized. The bulletin 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

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<sup>6</sup> 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.

<sup>7</sup> 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.

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.

#### **Executive Summary—Revenue Recognition**

- Recognition of revenue for high-technology clients is generally a more complex issue than it is in many industries due to such factors as the high number of contracts with customized terms.
- As the high-technology industry continues to evolve, new types of client arrangements may be seen and need to be evaluated as to the proper timing of revenue recognition.
- Auditors need to have a sound understanding of the underlying theories of revenue recognition and the specific pronouncements that may apply.

### **Software Developed or Obtained for Internal Use**

*What recent guidance has been issued with respect to accounting for the costs of internal use computer software?*

**.106** High-technology clients may have extensive computer systems that they use for internal management; for example, a telecommunications client may have a sophisticated system for tracking and billing customer usage. Having the most up-to-date systems can give high-technology audit clients a competitive edge in products, customer service, and so forth. A recent pronouncement addressed the issue of internal use computer software.

**.107** In March 1998, AcSEC issued SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. This SOP provides guidance on accounting for the costs of computer software developed or obtained for internal use. It requires the following.

- Computer software costs that are incurred in the preliminary project stage should be expensed as incurred. Once the capitalization criteria of the SOP have been met, external direct costs of materials and services consumed in developing or obtaining internal-use computer software; payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and interest costs incurred when developing computer software for internal use should be capitalized. Training costs and many kinds of data conversion costs should be expensed as incurred.
- Internal costs incurred for upgrades and enhancements that add functionality should be expensed or capitalized using the same criteria as for new software. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.

- External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized using the same criteria as for new software. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.
- Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*.
- The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.
- If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, should be applied against the carrying amount of that software.

SOP 98-1 identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use. The SOP applies to all nongovernmental entities and is effective for financial statements for fiscal years beginning after December 15, 1998. It should be applied to internal-use software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of the SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Costs incurred prior to initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred.

.108 In addition, EITF Issue No. 97-13, *Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Reengineering and Information Technology Transformation*, provides relevant guidance when an entity's information technology transformation project involves business process reengineering.

## **Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed**

*What guidance is available regarding accounting for the costs of computer software to be sold, leased, or otherwise marketed?*

.109 FASB Statement No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed* (FASB, *Current Text*, vol. 2, sec. Co2) specifies the accounting for the costs of computer software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process. It applies to computer software developed internally and to purchased software.

.110 Costs incurred internally in creating a computer software product shall be charged to expense when incurred as research and development until technological feasibility has been established for the product. Technological feasibility is established upon completion of a detail program design or, in its absence, completion of a working model. Thereafter, all software production costs shall be capitalized and subsequently reported at the lower of unamortized cost or net realizable value. Capitalized costs are amortized based on current and future revenue for each product with an annual minimum equal to the straight-line amortization over the remaining estimated economic life of the product.

.111 EITF Issue No. 96-6, *Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products*, raises the issues of how entities should account for the film and software costs associated with developing entertainment and educational products. However, because of the position taken by 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.

## In-Process Research and Development in a Purchase Business Combination

*What are the current significant issues with respect to in-process research and development in a purchase business combination?*

.112 A current significant issue in the high-technology industry is that in a number of business combinations, a significant amount of the purchase price was allocated to in-process research and development (IPR&D) and then written off. There has been much discussion in the press about this issue, and the SEC staff has expressed concern, also.

.113 The applicable literature here is APB Opinion 16, *Business Combinations* and related pronouncements (FASB, *Current Text*, vol. 1, sec. B50). Paragraphs B50.151 and B50.152 provide the following guidance for a purchase business combinations:

.151 Costs shall be assigned to all identifiable tangible and intangible assets, including any *resulting from* research and development activities of the acquired enterprise or *to be used in* research and development activities of the combined enterprise. Identifiable assets *resulting from* research and development activities of the acquired enterprise might include, for example, patents received or applied for, blueprints, formulas, and specifications or designs for new products or processes. Identifiable assets *to be used in* research and development activities of the combined enterprise might include, for example, materials and supplies, equipment and facilities, and perhaps even a specific research project in process. In either case, the costs to be assigned are determined from the amount paid by the acquiring enterprise and *not* from the original cost to the acquired enterprise. [FIN4, ¶4]

.152 The subsequent accounting by the combined enterprise for the costs allocated to assets *to be used in* research and development activities shall be determined by reference to Section R50, "Research and Development." Accordingly, costs assigned to assets to be used in a particular research and development project and that have no alternative future use (refer to Section R50, paragraph .107) shall be charged to expense at the date of consummation of the combination. [FIN4, ¶5] [Refer to paragraph .1001 for an EITF Issue that provides interpretive guidance on this paragraph.]

.114 The issue that has come up recently is how the purchase price has been allocated to the assets purchased, in particular, to IPR&D. Auditors of SEC registrants should be aware that the staff of the SEC have noted a number of problems regarding the valuation of IPR&D. One area noted frequently was the treatment of attributes of capitalized assets as attributes of IPR&D, for example, considering as IPR&D that portion of the purchased rights to technology that represents the future value of the right to enhance a product that has already been completed, on the theory that the right will be used in research and development. Other problems noted by the SEC staff include the definition of fair value and valuations that use a "relief from royalty" approach using average industry royalty rates.

.115 Many of these valuations are based on the work of a specialist, such as an appraiser. In these circumstances, auditors should follow the applicable guidance in SAS No. 73, *Using the Work of a Specialist*, and understand their responsibilities under that standard.

## New FASB Pronouncements

*What new accounting pronouncements have been issued this year by the FASB?*

### FASB Statement No. 132

.116 In February 1998, the FASB issued Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of FASB Statements No. 87, 88, and 106 (FASB, *Current Text*, vol. 1, secs.

P16, P40). FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statement Nos. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16), 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, sec. P16), and 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40), were issued. FASB Statement No. 132 suggests combined formats for presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

.117 FASB Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

### **FASB Statement No. 133**

.118 In June 1998, the FASB issued FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50). FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (2) a hedge of the exposure to variable cash flows of a forecasted transaction, or (3) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.119 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.120 For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a *fair value hedge*), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

.121 For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a *cash flow hedge*), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

.122 For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair value hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.



.123 For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.124 Under FASB Statement No. 133, an entity that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

.125 FASB Statement No. 133 applies to all entities. A not-for-profit organization should recognize the change in fair value of all derivatives as a change in net assets in the period of change. In a fair value hedge, the changes in the fair value of the hedged item attributable to the risk being hedged also are recognized. However, because of the format of their statement of financial performance, not-for-profit organizations are not permitted special hedge accounting for derivatives used to hedge forecasted transactions. FASB Statement No. 133 does not address how a not-for-profit organization should determine the components of an operating measure if one is presented.

.126 FASB Statement No. 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

.127 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It supersedes FASB Statement Nos. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. FASB Statement No. 133 also nullifies or modifies the consensus reached in a number of issues addressed by the EITF.

.128 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

#### **FASB Statement No. 134**

.129 In October 1998, the FASB issued FASB No. 134, *Accounting for Mortgaged-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB Statement No. 65.

#### **FASB Technical Bulletin No. 97-1**

.130 FASB Technical Bulletin No. 97-1, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*, provides guidance on accounting for certain employee stock purchase plans under FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FASB, *Current Text*, vol. 1, sec. C36). The bulletin does not address the accounting for those plans under APB Opinion 25, *Accounting for Stock Issued to Employees* (FASB, *Current Text*, vol. 1, sec. C47). The Bulletin applies to stock-based awards granted, renewed, or modified on or after January 1, 1998.

**EITF Consensus Positions**

.131 The status of issues considered recently by the EITF of the FASB can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

**Executive Summary—New FASB Pronouncements**

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statement Nos. 87, 88, and 106*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise, an amendment of FASB Statement No. 65* (issued October 1998).
- FASB Technical Bulletin No. 97-1, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*
- The status of issues considered recently by the EITF of the FASB can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

**New AICPA Accounting and Auditing Statements of Position**

*What new AICPA accounting and auditing SOPs have been issued this year?*

.132 Among those SOPs issued recently are three that were discussed previously in this *Audit Risk Alert*:

- SOP 97-2, *Software Revenue Recognition*
- SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*

.133 Additionally the following SOPs were also issued (discussed in *Audit Risk Alert—1998/99* [AAM section 8010]):

- SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
- SOP 98-5, *Reporting on the Costs of Start-Up Activities*
- SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*
- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*
- SOP 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission. This SOP has been posted in its entirety on the AICPA Web site, <http://www.aicpa.org>.*

## The Internet—An Auditor Research Tool

### *Can auditors use the Internet to perform more efficient audits?*

**.134** If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to SEC filings, professional news, state CPA society information, Internal Revenue Service information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, free of charge.

**.135** A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to—

- Obtain audit and accounting research information.
- Obtain texts such as audit programs.
- Discuss audit issue with peers.
- Communicate with audit clients.
- Obtain information from a client's Web site.
- Obtain information on professional associations.

**.136** There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; caution is advised when accessing data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

**.137** Some Web sites that may provide valuable information to auditors are listed in the following table. Additional Web sites are shown on in the table titled "Information Sources," at the end of this Audit Risk Alert.

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Accountant's Home Page	Resources for accountants and financial and business professionals	<a href="http://www.computercpa.com/">http://www.computercpa.com/</a>
AuditNet	Electronic communications among audit professionals	<a href="http://www.cowan.edu.au/mra/home.htm">http://www.cowan.edu.au/mra/home.htm</a>
CPAnet	Links to other Web sites of interest to CPAs	<a href="http://www.cpalinks.com/">http://www.cpalinks.com/</a>
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	<a href="http://www.cybersolve.com/tools1.html">http://www.cybersolve.com/tools1.html</a>
Double Entries	A weekly newsletter on accounting and auditing around the world	<a href="http://www.csu.edu.au/lists.anet/ADBLE-L/index.html">http://www.csu.edu.au/lists.anet/ADBLE-L/index.html</a>
The Electronic Accountant	World Wide Web magazine that features up-to-the minute news for accountants	<a href="http://www.electronicaccountant.com">http://www.electronicaccountant.com</a>

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	<a href="http://www.fedworld.com">http://www.fedworld.com</a>
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory	<a href="http://www.fsforum.com">http://www.fsforum.com</a>
General Accounting Office	Policy and guidance materials, reports on federal agency major rules	<a href="http://www.gao.gov">http://www.gao.gov</a>
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	<a href="http://www.tetranet.net/users/gaostl/guide.htm">http://www.tetranet.net/users/gaostl/guide.htm</a>
Hoovers Online	Online information on various companies and industries	<a href="http://www.hoovers.com">http://www.hoovers.com</a>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.kentis.com/ib.html">http://www.kentis.com/ib.html</a>
U.S. Tax Code Online	A complete text of the U.S. Tax Code	<a href="http://www.fourmilab.ch/ustax/ustax.html">http://www.fourmilab.ch/ustax/ustax.html</a>
Vision Project	Information on the profession's vision project	<a href="http://www.cpvision.org/horizon">http://www.cpvision.org/horizon</a>

## References for Additional Guidance

.138 Further information on matters addressed herein is available through various publications and services listed in the table titled "Information Sources," at the back of this Audit Risk Alert. Many nongovernment and some government publications and services involve a charge or membership requirement.

.139 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 telephone. Most fax services offer an index document, which lists titles and other information describing available documents.

.140 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.

.141 Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

.142 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.

.143 This Audit Risk Alert replaces *High-Technology Industry Developments—1997/98*. The *High-Technology Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other com-

ments that you have about the Alert would also be greatly appreciated. You may email these comments to [sfrohlich@aicpa.org](mailto:sfrohlich@aicpa.org) or write to:

Susan Frohlich, CPA—New York  
AICPA  
Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

.144 Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—1998/99* [AAM section 8010] and *Compilation and Review Alert—1998/99* [AAM section 8015], which may be obtained by calling the AICPA Order Department at 1-888-777-7077.

## Information Sources

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Organization	General Information	Fax Services	Internet	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	<a href="http://www.aicpa.org">http://www.aicpa.org</a>	
Financial Accounting Standards Board	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		<a href="http://www.fasb.org">http://www.fasb.org</a>	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	<a href="http://www.sec.gov">http://www.sec.gov</a>	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	<a href="http://www.doc.gov">http://www.doc.gov</a> <a href="http://www.bea.doc.gov">http://www.bea.doc.gov</a>	Public Information Office (202) 606-9900
Telecommunications Industry Association	2001 Pennsylvania Ave., NW Suite 800 Washington, DC 20006-1813	General Information (202) 457-4912	<a href="http://www.tiaonline.org">http://www.tiaonline.org</a>	
American Electronics Association	5201 Great American Pkwy. Suite 520 P.O. Box 54990 Santa Clara, CA 95056	General Information (408) 987-4200	<a href="http://www.aenet.org">http://www.aenet.org</a>	
Computing Technology Association	450 E. 22nd Street Suite 230 Lombard, IL 60148	General Information (708) 268-1818	<a href="http://www.cta.com">http://www.cta.com</a>	
Semiconductor Industry Association	181 Metro Drive Suite 450 San Jose, CA 95110	General Information (408) 436-6600	<a href="http://www.semichips.org">http://www.semichips.org</a>	
American Software Association c/o ITAA	1616 N. Fort Meyer Dr. Suite 1300 Arlington, VA 22209	General Information (703) 522-5055	<a href="http://www.itaa.org">http://www.itaa.org</a>	

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# AAM Section 8140

## *Real Estate Industry Developments—1998/99*

### In This Year's Alert . . .

- What is the overall condition of the real estate industry? What are the current trends?
- What is the overall condition of individual segments of the real estate industry? What are the significant trends in these industry segments?
- What are some of the important trends in the REIT industry? How have recent tax law changes affected REITs?
- How do current economic trends and conditions affect the risks associated with auditing real estate entities?
- What are some of the auditing and accounting issues that arise from the large number of consolidations taking place in the industry?
- How does the financial crisis in Asia affect the real estate industry?
- What is the Year 2000 Issue? How will it affect real estate entities? How does the Year 2000 Issue affect auditors?
- What auditing and accounting issues in the real estate industry continue to be of concern to auditors? How have current economic conditions affected these issues?
- What new auditing and accounting pronouncements have been issued this year?
- How can auditors use the Internet to plan and conduct the audit of a real estate entity? What kind of information is available on the World Wide Web? Where can this information be found?

\* \* \* \*

## Industry and Economic Developments

### General Industry Trends and Conditions

*What is the overall condition of the real estate industry?  
What are the current trends?*

.01 Through much of 1998, the prevailing mood within the real estate industry was one of restrained enthusiasm. The general sense of optimism reflected the continued strength of most real estate markets, as evidenced, for example, by increasing rents, lower vacancies, and a steady flow of capital into all industry segments. At the same time, many industry analysts urged caution and restraint, fearful that an irrational exuberance may lead to overbuilding and a downturn in the industry similar to that experienced at the beginning of this decade. Thus, in assessing current industry conditions, real estate companies and their auditors must strike an appropriate balance between optimism over the current state of affairs and a conservative outlook toward the future.

.02 The current state of the economy is positive. In spite of the recent volatility in the financial markets and the continuing political and economic crises in Asia and Russia, the fundamentals of the U.S. economy remain strong. The current economic expansion is now in its eighth year, one of the longest periods of sustained growth in history. Typically, inflation slows and then stops such periods of growth, but at this time, inflation remains well under control.

.03 The real estate industry has enjoyed a recovery similar to that of the economy as a whole. Only a few short years ago, the industry was plagued by illiquidity and a lack of capital. Now, after the demand for space has finally caught up with supply, that is no longer the case. Most industry analysts remain optimistic that the underlying conditions that have fueled the industry's recovery will continue into the near future. (Subsequent sections of this Audit Risk Alert discuss the economic conditions of specific industry segments.)

.04 However, this enthusiasm for the current state of affairs is tempered by an almost palpable sense of restraint. Historically, the real estate industry has been subject to cycles of boom and bust. Periods of increasing demand and rising prices are quickly followed by overbuilding and speculative construction, which ultimately leads to oversupply. Currently, after several years of recovery, the industry is on the verge of a significant new construction cycle, as the demand for real estate in several sectors is beginning to outpace supply. If developers, capital providers, and others in the industry can manage to discipline the coming development cycle, there is every reason to believe the industry will remain stable and avoid the dramatic downturns that have characterized its past.

.05 There have been several important trends in recent years in the real estate industry. One of the most far-reaching trends has been the continued consolidation within the industry. Driven by the philosophy that bigger is better, 1998 was marked by an unusually high number of corporate consolidations in all segments of the economy, and the real estate industry was no exception.

.06 Traditionally, real estate entities tended to be privately held, entrepreneurial enterprises. This type of structure provides two advantages: (1) the direct linkage between property performance and management compensation (superior motivation), and (2) quicker decision making (superior flexibility).

.07 Through consolidation, real estate companies are abandoning traditional organizational strategies and attempting to realize the benefits achieved by size. These targeted benefits include—

- Ready access to equity markets and other, cheaper sources of capital.
- Lower transaction costs by providing a broad range of integrated real estate services.
- Improved quality of management.
- Lower overhead by combining staffs.

In addition to mergers and acquisitions, real estate entities also are positioning themselves to realize some of the same benefits of size by forming large joint ventures and strategic alliances, which also is changing the nature of the industry.

.08 All this consolidation does not necessarily mean the death of the smaller, privately held, real estate company. Many of these companies have managed not only to survive but also to thrive by developing a niche market, such as military base privatization or assisted-living facilities. In the past few years there has been a marked increase in the number of real estate entities that are highly specialized, either by product type or geography.

.09 Another significant development in the real estate industry has been the trend toward public ownership of real estate, most notably through real estate investment trusts (REITs). REITs now control approximately 6 percent of the real estate market, but if you eliminate properties that are not likely to attract large investors (owner-user space and smaller properties in third- and fourth-tier cities) their share of the



market is even higher. According to the National Association of Real Estate Investment Trusts (NAREIT, the national trade association for real estate companies) the REIT industry has grown more than tenfold since 1991, and NAREIT anticipates continued rapid expansion.

.10 In 1998 there were several noteworthy shifts in the availability of capital for real estate investment. Throughout most of the year, the industry experienced what many considered to be an abundance of equity capital, driven by a return of institutional investors making direct investments and significant activity in the public markets. With such large amounts of capital at their disposal, most investors tended to consider larger properties as a way to realize efficiencies. A primary concern was whether investors, armed with an abundance of capital, could find deals that made economic sense — where the pricing reflected the fundamental supply and demand conditions of the market.

.11 During the last quarter of the year, a new concern worried industry analysts. Volatility and instability in global financial markets severely curtailed the demand for asset-backed bonds, such as commercial mortgage-backed securities (CMBSs). As a result, finance companies that provide and securitize loans to real estate companies experienced severe liquidity problems. For real estate companies, this meant a credit crunch that some analysts predicted was only the tip of the iceberg. It remains to be seen how widespread this lack of financing will become and ultimately how it will affect the real estate industry.

## Industry Segment Conditions

*What is the overall condition of individual segments of the real estate industry?*

*What are the significant trends in these industry segments?*

### Office Market Conditions

.12 The office market continues to be strong, characterized by a significant amount of investment activity, particularly from pension funds and REITs. Signs of the continued strength of office properties and current market trends include the following:

- *Lower vacancies.* The demand for office space has been fueled by increases in jobs, particularly in the financial services, high technology, and communications sectors. According to the real estate advisory firm Cushman & Wakefield, the national vacancy rate for downtown office buildings has dropped five percentage points since the second quarter of 1996. Lower vacancies have resulted in higher rental rates and the disappearance of large rental concessions.
- *Lower initial cap rates.* The supply of capital to this sector of the real estate market has put a downward pressure on cap rates. Additionally, many investors of office properties are acting as arbitrageurs, focusing on acquiring properties with soon-to-expire rents at below market rents. The strategy is to realize significant appreciation in the value of the property by quickly rolling over these old leases to higher, market rents. This trend also has contributed to lowering cap rates.
- *Shift away from suburban office markets.* Investors in office properties have been turning away from smaller, suburban properties and toward larger properties in the downtown, central business districts.
- *Increase in new construction.* During the first half of 1998, approximately 350,000 square feet of new downtown office space was completed. In contrast, the industry expected 2,900,000 square feet to be completed during the second half of 1998. Estimates of new office construction for the next two years are 2,200,000 square feet in 1999 and another 2,000,000 square feet in the year 2000.

### Industrial Market Conditions

.13 The growth of exports and the resulting revitalization of the U.S. manufacturing industries have played a large role in the economic expansion of the 1990s. This growth in manufacturing has resulted in a healthy industrial real estate market, particularly for warehouse and distribution facilities. However, several significant trends are reshaping this segment of the industry, including—

- *Changing fundamentals for warehouse and distribution facilities.* Vacancies for warehouse and distribution facilities are beginning to edge upwards. Additionally, there has been a surge of recent construction of these types of properties, which may outpace demand.
- *Rising demand for light assembly and research and development (R&D) facilities.* In the past few years developers and investors have been focusing on warehouse and distribution facilities, largely ignoring the more labor-intensive light assembly and R&D properties. As a result, the supply of these properties has not kept pace with demand. And demand is expected to increase, particularly for R&D, as U.S. corporations will spend heavily in this area to keep up with the quickening pace of technological change.

### **Retail Market Conditions**

.14 For the past few years the retail market has been plagued by high vacancy rates and an oversupply of space. Competition in the retail industry is fierce and will continue into the future. This heavy competition will continue to place upward pressure on cap rates for retail real estate properties.

.15 However, there are signs of improvement in the retail industry. Most notably, the economic recovery of the 1990s has added billions of dollars in consumer purchasing power to the economy, and median household income, adjusted for inflation, is the highest it's been in nearly a decade. As a result, retail property productivity, measured in terms of sales per square foot, has begun to show modest improvement.

.16 One significant operating trend for the retail segment has been the development of specializations and niche marketing strategies. To distinguish themselves from their competitors, many malls have had to focus on a particular niche, such as entertainment or travel-related tie-ins. Traditional suburban shopping centers that have not yet adopted such an approach will be challenged to reinvent themselves and maintain their customer base. Many malls are adding services such as medical offices or dentists to replace their retail tenants.

### **Residential Market Conditions**

.17 Both the multifamily and single-family markets are strong and should remain relatively stable into the near future. According to a recent report by the Census Bureau, the percentage of U.S. households that own their own home is at an all-time high. The Census Bureau also projects annual increases of approximately 1.1 percent (1.15 million units) in the number of U.S. households for each of the next ten to fifteen years. This projected increase together with the current low mortgage interest rates make most analysts bullish on the single-family housing market.

.18 The projected increase in the number of households also bodes well for the multifamily housing market. Research performed by Landauer Research Group indicates that the market should be able to absorb 325,000 new units per year. Apartment rents continue to rise at 3 percent to 5 percent per year, which—although a positive sign—is slower than recent increases due to the effects of recent new apartment construction. Although the multifamily market remains strong, slower growth is expected in most regions of the country.

.19 Finally, the most significant demographic trend affecting the residential market is the overall aging of the American population. This has created a fast-growing niche in the senior housing market. This market is not homogeneous and covers a wide range of living arrangements, including active retirement communities, congregate care facilities, and continuing care programs. Many developers of senior housing are partnering with health care providers.

### **Real Estate Investment Trusts (REITs)**

*What are some of the important trends in the REIT industry?  
How have recent tax law changes affected REITs?*

.20 As mentioned earlier, REITs continue to grow in size and importance to the real estate industry. Other important trends for REITs include—

- *Consolidation and specialization.* Like the industry as a whole, REITs continue to grow through merger and acquisition. Also, like many other segments of the industry, REITs are increasingly developing a niche strategy, focusing exclusively on narrow segments of the industry such as entertainment properties or prisons.
- *Stock prices reflecting underlying asset value.* Recently, REIT stocks have traded at a premium above the net asset value of the underlying real estate. That situation is unlikely to continue, so look for stock prices to come more into line with net asset value.

.21 The Taxpayer Relief Act of 1997 (TRA '97) became law on August 5, 1997. Several provisions in that law affected REITs—both the requirements for qualification as a REIT and the taxation of a REIT. Under TRA '97—

- A REIT may now earn up to 1 percent of its gross income, on a property-by-property basis, from nominal services to customers and still treat amounts received with respect to that property as rent.
- REIT shareholders will receive a tax credit when a REIT sells a property, retains the sales proceeds, and pays a corporate level tax.
- The 30 percent gross income test for qualification as a REIT has been repealed.
- A REIT that fails to send timely shareholder letters will be levied a penalty of \$25,000 rather than be disqualified. Additionally, a REIT that sends out shareholder letters and does not know of a "five or fewer" violation is now deemed to satisfy this ownership test.
- For purposes of the 95 percent gross income test, REIT hedging rules are expanded so that income from all types of liability derivatives are now considered qualifying income.

.22 On July 22, 1998, the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 became law. Although the law focuses on overhauling the operations of the IRS, it also contains provisions affecting paired-share REITs, essentially limiting the tax benefits of those entities.

#### Executive Summary—Industry and Economic Developments

- Through much of the year, the real estate industry was in full recovery and at the beginning of a period of significant new construction. Analysts had urged restraint to avoid the kind of market downturn experienced at the beginning of this decade. However, a shortage of the availability of commercial credit developed near year end, threatening continued industry growth.
- Significant consolidation within the industry and the trend toward public ownership, most notably through REITs, are two significant trends that are reshaping the nature of the industry.
- The office market is strong, marked by lower vacancies and cap rates. Significant increases in new construction are planned for the next two years.
- The industrial market remains healthy, although vacancies for warehouse and distribution facilities are beginning to edge upwards.
- The retail market has been plagued by high vacancy rates and an oversupply of space, although there are signs that this is beginning to change. Specialization and niche marketing strategies are changing this segment of the industry.
- Multifamily and single-family residential markets remain strong. Projected increases in the number of U.S. households should keep this market strong into the future.
- REITs continue to grow in size and importance to the real estate industry.

## Current Audit Issues

### Assessing Audit Risks in the Current Environment

*How do current economic trends and conditions affect the risks associated with auditing real estate entities?*

.23 Auditors should be aware of their responsibilities as set forth under Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311). SAS No. 22 requires, in part, that in planning the audit, the auditor should consider matters affecting the industry in which the entity operates, including current economic conditions. With respect to audits of real estate entities, this would include the factors described in the previous section. In particular, the economic conditions just described may be relevant to the auditor when—

- Evaluating audit risk and the business risks faced by the entity.
- Considering the reasonableness of significant accounting estimates and their underlying assumptions.

### Evaluating Audit Risks

.24 An auditor's evaluation of audit risk should start with a good understanding of the client's business. To develop a good understanding of a real estate entity, an auditor should be knowledgeable about the entity's strategies for dealing with business conditions, both current conditions and those most likely to exist in the near future. In the real estate industry, business conditions vary greatly across property types and from region to region. The risks associated with developing office buildings are different from those faced by a homebuilder; a warehouse facility in the Northeast may face different issues than a similar facility located on the Pacific Coast. For this reason, an auditor must be knowledgeable about property types (for example, office, retail, or industrial) and the location in which the entity operates.

.25 Audit risk can be altered when a real estate entity enters into new product types or new geographic markets. Auditors should be aware that current economic conditions may force their real estate clients to expand beyond their traditional sphere of operations. Industry trends that may affect an entity in this way include—

- *Specialization.* The increasing specialization of real estate entities and the necessity of niche marketing strategies may require entities to expand the geographic scope of their operations. For example, an operator of assisted living facilities in the Southwest may have to expand to other locations in order to keep growing.
- *Availability of capital.* The abundance of capital in the real estate industry has resulted in a highly competitive search among investors for economic deals. In the search for these deals, entities seeking to acquire real estate may consider property types or locations that are new to them.

.26 During audit planning, auditors should identify new product types or locations and should carefully assess the risks associated with the client's change in operating strategy.

.27 Additionally, the real estate industry has always been characterized by a large number of unique, highly complex transactions. There is no reason to believe that the current environment will change this industry characteristic. For example, as the industry has recovered and significant construction activity begun, land has become difficult to acquire in some of the country's hottest markets. To secure rights to the land they need, developers and builders have been forced to create sophisticated and complex arrangements, alliances, and transactions. The sale or leasing of property and its financing are two other areas where creative, complex transactions tend to proliferate. Auditors should identify complex transactions during audit planning and take steps to ensure that they are accounted for in accordance with generally accepted accounting principles (GAAP).

.28 Finally, auditors should monitor the credit crunch that developed toward the end of 1998 to see how it affects their clients. Because of a lack of financing, some transactions, including debt refinancings, may not close. Auditors should consider whether a lack of available funding raises questions about an entity's ability to continue as a going concern.

### ***Auditing Accounting Estimates***

.29 The financial statements of real estate entities often include accounting estimates. For example, supplemental current values of real estate assets and the recognition and measurement of impairment losses both require management to make estimates of future events or assumptions about current conditions.

.30 Authoritative guidance on auditing accounting estimates is provided in SAS No. 57, *Auditing Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342). Additionally, the AICPA publication *Auditing Accounting Estimates and Other Soft Accounting Information* offers nonauthoritative tips and techniques on the subject.

.31 Currently, the real estate industry is healthy and in the early stages of significant construction activity in many segments. As the new construction is completed, the supply of space may outpace demand, creating downward pressure on rental rates and increasing vacancies. Certain estimates (for example, expected future cash flows used in the determination of possible asset impairment) require management to make assumptions about future events and conditions. Auditors should consider carefully whether these assumptions are not overly optimistic; they should consider the anticipated future conditions of the marketplace and not the conditions as they exist today.

### **Audit Implications of Business Combinations in the Real Estate Industry**

*What are some of the auditing and accounting issues that arise from the large number of consolidations taking place in the industry?*

.32 Consolidation in the real estate industry has created a shift away from privately owned, somewhat loosely controlled entities and toward larger, corporate, and more professionally managed organizations. This trend can affect audit planning in a number of ways, including—

- *Changes in vulnerability to fraud.* SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316) describes two types of fraud: fraudulent financial reporting and misappropriation of assets. Smaller, owner-managed entities tend to be more vulnerable to employee theft and defalcation and other misappropriations of assets. Larger corporations with effective internal controls, although vulnerable to misappropriation of assets, also tend to be much more susceptible to fraudulent financial reporting. Auditors accustomed to auditing small, owner-managed entities should be careful not to overlook fraud risk factors relating to fraudulent financial reporting when those entities become part of larger, more structured organizations.
- *Assessing control risk below the maximum.* For most small business entities, the most efficient audit approach usually involves assessing control risk at the maximum and performing a primarily substantive audit. Out of necessity, larger organizations usually have more formal internal controls in place. To the extent that these controls are effective in reducing control risk, an auditor should consider an audit strategy of assessing control risk below the maximum in order to limit the nature, timing, and extent of substantive procedures.
- *Communications between predecessor and successor auditors.* Business combinations often result in the gain of a client for one auditor and a loss of a client for another. Thus, in the current economic environment, auditors may be more likely to find themselves in the role of either a predecessor or successor auditor. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place.

.33 In addition to the issues associated with planning the audit of an entity that has been involved in a business combination, auditors should assess whether management's accounting for the business combination is in conformity with GAAP. Relevant pronouncements include—

- Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FASB, *Current Text*, vol. 1, sec. C51).
- AICPA Accounting Principles Board (APB) Opinion No. 16, *Business Combinations* (FASB, *Current Text*, vol. 1, sec. B50).
- AICPA Statement of Position (SOP) 78-9, *Accounting for Investments in Real Estate Ventures*.
- AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (FASB, *Current Text*, vol. 1, sec. C51).

## Impact of the Asian Crisis on the U.S. Real Estate Industry

### *How does the financial crisis in Asia affect the real estate industry?*

.34 The financial problems in Asia have their root in the deep and prolonged recessions in countries such as Indonesia, Thailand, South Korea, Singapore, Malaysia, and Japan. These economies have been plagued by rising unemployment, upward pressure on interest rates, and falling asset prices. The resulting declines in currency values and financial markets have led to the weakening or failure of many of their major financial institutions. And the risk of further adverse developments in Asia remains substantial, with the prospect of economic recovery at least two or three years away. Given the pervasive interconnections of virtually all economies and financial systems in the world today, the associated uncertainties for the U.S. economy remain substantial as well.

.35 Not all of the implications of the Asian financial crisis are negative. As the dollar strengthens against the Asian currencies, imports from those countries become cheaper. This in turn will help keep inflation in check, which in turn may create downward pressure on interest rates.

.36 There is no way of knowing for sure how and to what degree the Asian financial crisis will affect the U.S. real estate industry, and many analysts see the situation as creating both threats and opportunities for industry entities.

### **Threats**

.37 As indicated previously, the growth in the export of goods and services has been a significant underlying cause for the expansion of the U.S. economy. This growth in exports also has been a driving force in rising property values for office and industrial properties connected to the manufacture and distribution of goods for export. The financial problems in Asia undoubtedly will reduce the amount of goods exported to that region.

.38 Many analysts contend that a reduction in exports to Asia will have only a nominal effect on most real estate markets. In making those predictions they cite other strong economic fundamentals, such as continued domestic demand for American products, as being powerful enough to mitigate any negative consequences of reduced exports to Asia. Nevertheless, auditors should consider the extent to which an entity's underlying real estate assets are tied to Asian exports.

### **Opportunities**

.39 The depressed property values across much of Asia provide an opportunity for U.S. real estate entities seeking to make either a direct investment in Asian real estate or in pools of loans secured by Asian property.

The abundance of capital may encourage U.S. investors to look to Asia for economic real estate deals. Auditors should assess the risks of overseas investment. Investment in foreign property may involve economic, political, and cultural considerations and risks the entity has never before encountered.

### The Year 2000 Issue

*What is the Year 2000 Issue? How will it affect real estate entities?  
How does the Year 2000 Issue affect auditors?*

.40 The Year 2000 Issue relates to the inability of many electronic data processing systems to accurately process year-date data beyond the year 1999. This is because the majority of computer programs in use today have been designed to store dates in the dd/mm/yy (date/month/year) format, thus allowing only two digits for each date component. For example, the date December 31, 1998, is stored in most computers as "12/31/98." Inherent in programming for dates in this manner is the assumption that the designation "98" refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit year input fields will cause many computers to treat the entry "00" as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00) as January 1, 1900, and process that data incorrectly, or perhaps not at all.

.41 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year 2000 ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur this year. Some software programs have assigned special meanings to date entries coded "xx/xx/98" or "xx/xx/99," and therefore may not process these transactions correctly. Similarly, failures may take place this year when systems perform calculations into or beyond the year 2000.

.42 The Year 2000 Issue affects real estate entities in one of two general ways. First, as is the case for any other company, the Year 2000 Issue will affect the computer systems that handle accounting information and other transaction processing. Companies that run off-the-shelf, Windows-based systems should have a relatively easy time fixing any problems because most vendors have or will have versions of their software that are year 2000 compliant. However, problems could arise with—

- *DOS-based software.* Many companies have experienced year 2000 problems with DOS-based software. Unfortunately, most real estate companies currently run DOS-based property management systems because Windows-based systems are rare.
- *Legacy systems.* Some real estate companies run custom software written in older programming languages. These "legacy" systems must be updated to become year 2000 compliant.

.43 The second Year 2000 Issue faced by real estate companies is less obvious but potentially more difficult to solve. Many building systems have embedded computer microprocessors that allow them to function. Such embedded computers can be found in virtually any automated system that controls building functions. The most important systems to check for year 2000 compliance include—

- Centralized facilities management systems.
- Energy management systems.
- Elevator and escalator controls.
- Environmental management systems.
- Fire control systems.
- Building security systems.

.44 The difficulty with embedded computer processors is that the problems related to the year 2000 are hard to find, numerous, and oftentimes connected to other systems and to each other.

.45 First, it must be understood that it is the responsibility of an entity's management to assess and remediate the effects of the Year 2000 Issue on an entity's systems—not the auditor's. The Year 2000 Issue does not create additional responsibilities for the auditor. Under generally accepted auditing standards (GAAS), 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Year 2000 Issue or by some other cause.

.46 The AICPA's *Audit Risk Alert—1998/99* [AAM section 8010] provides a more detailed discussion of how the Year 2000 Issue affects auditors, including—

- Addressing the issue in engagement letters.
- Highlighting the issue in management letters.
- Identifying the accounting issues and related authoritative pronouncements.
- Assessing possible asset impairment.
- Assessing the adequacy of disclosure for public and nonpublic entities.
- Identifying potential legal threats.

.47 Auditing guidance relating to the Year 2000 Issue has been developed by the Audit Issues Task Force (AITF) of the Auditing Standards Board (ASB). The AITF has issued the following auditing Interpretations, all of which are discussed in more detail in the *Audit Risk Alert—1998/99* [AAM section 8010].

- Interpretation No. 4, "Audit Considerations for the Year 2000 Issue," of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311.38-.47), discusses the auditor's responsibility with regard to the Year 2000 Issue, how it affects planning for an audit of financial statements conducted in accordance with GAAS, and under what circumstances the Year 2000 Issue may result in a reportable condition.
- Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19-.31), clarifies the responsibilities of service organizations and service auditors with respect to information about the Year 2000 Issue in a service organization's description of controls.
- Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.03-.27), provides guidance regarding the identification and evaluation of conditions and events of the type identified in SAS No. 59 that relate to the Year 2000 Issue.

.48 In addition, the AITF issued attestation Interpretation No. 1, "Consideration of the Year 2000 Issue When Examining or Reviewing Management's Discussion and Analysis," of Statement on Standards for Attestation Engagements (SSAE) No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 9700.01-.17), which provides guidance on the practitioner's responsibility with respect to year 2000 disclosures in Management's Discussion and Analysis (MD&A).

.49 A more comprehensive discussion of the numerous auditing and accounting issues related to the Year 2000 Issue is presented in the AICPA publication *The Year 2000 Issue: Current Accounting and Auditing Guidance*. The publication has been updated for recent developments and provides a wealth of information for auditors including—

- Introduction to, and implications of, the Year 2000 Issue.



- Industry-specific considerations.
- Financial reporting issues.
- Auditing issues.
- Disclosure considerations.
- Auditor communications.
- Practice management issues.

This document can be obtained, free of charge, at the AICPA's Web site at [www.aicpa.org](http://www.aicpa.org).

.50 Additionally, the Building Owners and Managers Association (BOMA) International has published a comprehensive guide titled *Meeting the Year 2000 Challenge: A Guide for Property Professionals*. The guide contains model letters and contracts, checklists, inventory forms covering twenty-five different building systems, and model language for business and legal documents. Portions of the guide can be downloaded at the BOMA Web site ([www.boma.org](http://www.boma.org)).

#### Executive Summary—Current Audit Issues

- Current economic conditions and other competitive factors may force real estate companies to expand beyond their traditional locations, product types, or both. These types of operational changes can alter the risks faced by real estate entities and their auditors.
- Accounting estimates based on assumptions about future events and operating conditions should take into account projected new construction and other competitive factors expected to exist.
- Business combinations have created a shift away from privately owned, somewhat loosely controlled entities and toward larger, corporate-structured, more professionally managed organizations. This shift may require auditors to reevaluate their audit strategies, particularly in their approach to internal controls and the assessment of fraud risk.
- The Asian economic crisis provides both threats and opportunities for real estate entities. Auditors should assess how the crisis affects audit risk.
- The Year 2000 Issue will affect the computer systems of real estate entities. More importantly, it will affect the "embedded" microprocessors that operate commercial building systems such as elevators and security and environmental management systems.

## Auditing and Accounting Issues of Continuing Importance

*What auditing and accounting issues in the real estate industry continue to be of concern to auditors? How have current economic conditions affected these issues?*

### Revenue Recognition

.51 After years of hesitancy, the fact that the real estate industry recovery is now under way may lead to overly optimistic forecasted improvements in financial results that may not materialize fully. Auditors should consider the appropriateness of their clients' revenue recognition policies or, especially, changes to those policies. Some clients may view the industry recovery 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 entities, auditors should consider carefully whether the criteria in FASB Statement No. 66, *Accounting for Sales of Real Estate* (FASB, *Current Text*, vol. 1, sec. R10), have been met.

.52 Auditors also should continue to be alert for—

- *“Put” arrangements.* Put arrangements may commit a 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. These arrangements can significantly affect revenue recognition. In some cases, put arrangements may not be formally documented, so auditors should consider the facts and circumstances surrounding property sales to be sure there are no formal or informal arrangements of this kind.
- *Direct or indirect seller financing.* Auditors should 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 related party transactions that require disclosure as described in FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. 1, sec. R36). Auditors should refer to SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334, “*Related Parties*”) for guidance on procedures that should be considered to identify related party relationships and transactions.
- *Creative funding arrangements.* Some real estate transactions are structured to achieve a desired tax result. Auditors should analyze such creative funding arrangements to ensure that the transaction has been accounted for in accordance with GAAP.

.53 FASB Statement No. 66 describes examples of real estate transactions, including sales of corporate stock of enterprises with substantial real estate, sales of partnership interests, and sales of time-sharing interests. Questions have been raised as to whether the sale of these investments should be accounted for under Statement No. 66 in accordance with FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FASB, *Current Text*, vol. 1, sec. F38). In the FASB’s Emerging Issues Task Force (EITF) Issue No. 98-8, *Accounting for Transfers of Investments That Are in Substance Real Estate*, a consensus was reached that the sale or transfer of an investment in the form of a financial asset that is in substance real estate should be accounted for in accordance with Statement No. 66.

## Asset Impairment

.54 In spite of the continued recovery of most real estate markets, auditors must remain vigilant for the possible impairment of real estate assets. The subjectivity required in determining the recognition and measurement of any impairment loss reinforces the need for careful planning and execution of audit procedures in this area.

.55 FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08), provides the primary guidance on accounting for the impairment of real estate assets.<sup>1</sup> In general, the accounting for the impairment of real estate depends on whether the property is to be held for investment or held for disposal. Projects under development are accounted for in the same manner as those held for investment.

.56 Note that Statement No. 121 does not provide exceptions for assets subject to nonrecourse debt. The FASB believes the recognition of an impairment loss should be made without regard to the nature of the debt.

## Real Estate Properties Held for Investment

.57 Real estate held for investment and projects under development should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that

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<sup>1</sup> The Financial Accounting Standards Board (FASB) currently is preparing an exposure draft that would amend Statement No. 121. As part of this project, certain issues specifically related to real estate assets are being addressed. Progress on the deliberations of this matter is posted regularly on the FASB Web site.

impairment may have occurred. 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.
- 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 GAAP due to improper valuation of assets.)

.58 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. An asset is deemed to be impaired if its carrying amount 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. Restoration of previously recognized impairment losses is prohibited.

.59 Lack of an asset-impairment evaluation system may indicate a material weakness in an entity's internal controls. 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 write-downs, and will increase the likelihood that differences will result.

### ***Real Estate to Be Disposed Of***

.60 All real estate to be disposed of that is not subject to the provisions of APB Opinion 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* (FASB, *Current Text*, vol. 1, sec. I13), of 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 write-downs 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* (FASB, *Current Text*, vol. 2, sec. Re2).

.61 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?

## Cost Capitalization

.62 The real estate industry is now entering the beginning of what could be a substantial construction period. The costs incurred in developing real estate projects range broadly from direct, “brick and mortar” costs to indirect, general and administrative costs. Judgment can be required when determining whether certain costs should be capitalized or expensed, and auditors whose clients are involved in real estate development should consider whether development costs have been capitalized and allocated to individual projects in accordance with GAAP.

.63 The primary guidance on accounting for real estate development costs is provided in FASB Statement No. 67, which establishes whether costs associated with acquiring, developing, constructing, selling, and renting real estate projects should be capitalized. In general, costs that are clearly associated with the acquisition or development of the property should be capitalized; all other costs should be expensed as incurred. Statement No. 67 also provides guidance on allocating capitalized costs to individual projects.

.64 Additionally, FASB Statement No. 34, *Capitalization of Interest Costs* (FASB, *Current Text*, vol. 1, sec. 167), provides guidance on capitalizing interest costs as part of the cost of an asset. The underlying concept in this Statement is that entities should capitalize all the interest that theoretically could have been avoided if expenditures for the asset had not been made.

.65 EITF Issue No. 97-11, *Accounting for Internal Costs Relating to Real Estate Property Acquisitions*, addresses the issue of whether the internal costs of identifying and acquiring properties should be capitalized as part of the cost of an acquisition of real estate. In March 1998 the Task Force reached a consensus that the accounting for such costs depends on whether the property acquired is to be classified as an operating or nonoperating property.

.66 If the property is to be classified as an operating property at the date of the acquisition, then internal costs of preacquisition activities should be expensed as incurred. On the other hand, if a property is to be classified as nonoperating, then the internal costs of preacquisition activities should be capitalized as long as—

- They are directly identifiable with the property.
- They were incurred subsequent to the time that acquisition of the property was considered probable.

## Accounting for Lease Modifications

.67 As the demand for space begins to outstrip supply, property owners may seek to negotiate rental increases and shorter lease terms with their tenants. EITF Issue No. 95-17, *Accounting for Modifications to an Operating Lease That Do Not Change the Lease Classification*, provides guidance when an operating lease is changed by shortening the lease term and increasing the lease payments over the shortened term, but the modifications do not change the lease classification. Under those conditions, the owner’s management must determine whether the increased lease rents represent a true modification of future lease payments or are in substance a termination penalty.

- If the increase represents a modification of future lease payments, then the increase should be accounted for prospectively over the shortened lease term.
- If the increase represents a termination penalty, then it should be charged to income in the period in which the lease is modified.

.68 To determine the nature of the modification, the increased lease payments should be compared to market rents and the shortened lease term compared to the original lease's remaining term. The closer the increased payments are to market rents, the more likely the increase represents a modification of future lease payments. However, the greater the difference between the modified term and the original lease's remaining term, the more likely the increase represents a termination penalty.

### **Regulatory Considerations**

.69 A number of real estate entities and certain real estate transactions are subject to government regulation. Auditors should consider these regulations in light of their potential effect on the financial statements being audited.

.70 Additionally, SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 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 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.

### ***U.S. Department of Housing and Urban Development Regulations***

.71 Through the Federal Housing Administration, the U.S. Department of Housing and Urban Development (HUD) regulates the development and operation of all of the housing projects for which it insures mortgages or provides rent subsidies. Entities that receive financial assistance from HUD are required to submit audited financial statements to HUD annually. Those audits are required to be performed in accordance with GAAS; *Government Auditing Standards*, issued by the Comptroller General of the United States; and the *Consolidated Audit Guide for Audits of HUD Programs*, issued by the HUD Office of the Inspector General.

.72 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) who 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.

### ***Interstate Land Sales and Full Disclosure Act***

.73 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 makes it unlawful for a developer to sell or lease, by use of the mail or any other means of interstate commerce, any land offered as part of a common promotional plan unless the land is registered with the Office of Interstate Land Sales Registration. The Act requires that a printed property report be furnished to all prospective purchasers or lessees. Similarly, the Federal Trade Commission has the authority to act on unfair or deceptive trade practices with respect to real estate sales, particularly as they relate to the marketing and selling activities of real estate companies.

### ***Regulation Z of the Consumer Credit Protection Act***

.74 Since most real estate purchases are made on credit, truth-in-lending laws can have a significant effect on real estate financing transactions. Regulation Z of the Consumer Credit Protection Act prescribes requirements for both creditors and borrowers for full disclosure of credit costs 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.

## Segment Disclosures and Non-GAAP Measures of Performance

.75 Many real estate industry executives have long believed that GAAP measures of net income obscure or, in some cases, actually distort the true performance of real estate entities. Their argument is that GAAP methods of depreciation are not a true reflection of the economic depreciation and appreciation experienced by real estate assets.

.76 In 1991, NAREIT adopted the term funds from operations (FFO) as a measurement that would supplement GAAP measures of net income. In 1995 the term was clarified and generally is measured as GAAP net income, excluding gains or losses from debt restructuring and sales of property, plus real estate depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures.

.77 For the past few years, publicly held real estate entities have been presenting FFO or, in some cases, "operating income before depreciation and amortization and write-downs of real estate" in Selected Financial Data and Management's Discussion and Analysis (MD&A). The Securities and Exchange Commission (SEC) staff believes that such financial statement captions are inappropriate because they suggest that the amount represents cash flow for the period, which rarely is 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 consistent with that appearing in the financial statements.

.78 The SEC also notes that neither GAAP nor SEC authoritative accounting literature provides a definition for FFO. The SEC staff's views with respect to the presentation of a cash flow measure as a proxy for net income and the presentation of funds generated from operations are expressed in Accounting Series Release 142. This release 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 or an appropriate measure on which to compute and base dividends. Net income and cash flows from operating, investing, and financing activities remain the appropriate measures.

.79 In June 1997, the FASB issued Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30). This Standard became effective for financial statements for periods beginning after December 15, 1997.

.80 Among other things, Statement No. 131 establishes standards for the way that public companies report information about operating segments in annual financial statements. The Statement requires that a public business enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assess performance. Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments.

.81 FASB Statement No. 131 also requires that a public business enterprise report a measure of segment profit or loss, certain specific revenue and expense items, and segment assets. It requires reconciliations of total segment revenues, total segment profit or loss, total segment assets, and other amounts disclosed for segments to corresponding amounts in the enterprise's general purpose financial statements.

.82 Under Statement No. 131, some industry advocates have encouraged REITs to report FFO as their measure of segment profit and loss in the notes to the financial statements. In May 1998, the EITF issued

Topic No. D-70, *Questions Related to the Implementation of FASB Statement No. 131*. In answering questions related to Statement No. 131, the FASB responded that if non-GAAP measures of performance are evaluated by the chief operating decision maker for purposes of evaluating segment performance, then those measures should be disclosed as required by Statement No. 131. Note, however, that FASB Statement No. 131 also requires the segment information to be reconciled to the entity's financial statements. Although EITF Topic No. D-70 specifically addresses earnings before interest, taxes, depreciation, and amortization (EBITDA), it also applies to any similar situation, in this case, FFO.

.83 Auditors whose clients report FFO as segment information must be sure that the accounting policy and procedures for disclosing FFO are in conformity with Statement No. 131. Auditors should determine that management uses FFO in running the business and that the calculation of FFO is consistent with the way FFO is described in the financial statements. Auditors also should test the reconciliation of FFO to the financial statements.

### Accounting for Percentage Rents

.84 Some rental agreements, particularly those in the retail industry, provide for minimum rental payments plus contingent rents based on the lessee's operations, for example a future specified sales target. Often, the specified target would not be achieved until the later months of the fiscal year.

.85 In the past, the accounting literature was silent on how contingent rent based on future specified targets should be accounted for in interim financial reporting periods. In practice, many companies accrued these amounts in interim financial statements when it became probable that specified targets would be achieved, rather than waiting until the period when the targets actually were met.

.86 EITF Issue No. 98-9, *Accounting for Contingent Rent in Interim Financial Periods*, reached a consensus that reverses this long-standing practice. Under Issue No. 98-9, lessors must now defer recognition of contingent rental income in interim periods until the specified target that triggers the contingent rental income is achieved. However, at its September 1998 meeting, the EITF decided to reconsider the consensus reached on Issue No. 98-9. Auditors are encouraged to monitor the debate on this issue and its eventual resolution.

#### Executive Summary—Audit and Accounting Issues of Continuing Importance

- Revenue recognition continues to be a concern as some clients may view the industry recovery 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 spite of the continued industry recovery, auditors must remain vigilant for the possible impairment of real estate assets.
- The industry is at the beginning of a new development cycle. Auditors should be sure to consider whether costs are capitalized in accordance with GAAP.
- The current economic conditions may lead to property owners attempting to negotiate rental increases and shorter lease terms with their tenants. EITF Issue No. 95-17 addresses the accounting for such lease modifications.
- A number of real estate entities and certain real estate transactions are subject to government regulation under the Interstate Land Sales and Full Disclosure Act, Regulation Z of the Consumer Credit Protection Act, and audit standards promulgated by HUD.
- FASB Statement No. 131 relating to the disclosure of segment information may result in some entities reporting funds from operations (FFO) in the notes to the financial statements. Auditors should consider these disclosures of FFO carefully to be sure they comply with the requirements of Statement No. 131.
- The widely accepted industry practice of accounting for contingent rentals in interim financial statements has changed as a result of the issuance of EITF Issue No. 98-9.

## New Auditing and Accounting Pronouncements

*What new auditing and accounting pronouncements have been issued this year?*

.87 New authoritative pronouncements that deal specifically with real estate industry matters have been discussed elsewhere in this Alert. Auditors should consult *Audit Risk Alert—1998/99* [AAM section 8010] for a more detailed discussion of all new standards not discussed in this Alert. *Audit Risk Alert—1998/99* [AAM section 8010] also describes recently issued SSAEs, auditing Interpretations, attestation Interpretations, AITF Advisories, FASB Technical Bulletins, and EITF Consensus Positions.

.88 The table below summarizes the AICPA SASs, FASB Statements, and AICPA SOPs issued during the past year.

<b><i>AICPA Statements on Auditing Standards</i></b>	
SAS No. 86	<i>Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties</i>
SAS No. 87	<i>Restricting the Use of an Auditor's Report</i>
SAS No. 21	<i>Segment Information — Rescinded</i>
<b><i>FASB Pronouncements</i></b>	
Statement No. 132	<i>Employers' Disclosures about Pensions and Other Postretirement Benefits</i> (an amendment of FASB Statements No. 87, 88, and 106)
Statement No. 133	<i>Accounting for Derivative Instruments and Hedging Activities</i>
Statement No. 134	<i>Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise</i> (an amendment of FASB Statement No. 65)
<b><i>AICPA Statements of Position</i></b>	
SOP 97-2	<i>Software Revenue Recognition</i>
SOP 97-3	<i>Accounting by Insurance and Other Enterprises for Insurance-Related Assessments</i>
SOP 98-1	<i>Accounting for the Costs of Computer Software Developed or Obtained for Internal Use</i>
SOP 98-2	<i>Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising</i>
SOP 98-3	<i>Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards</i>
SOP 98-4	<i>Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition.</i>
SOP 98-5	<i>Reporting on the Costs of Start-Up Activities</i>
SOP 98-6	<i>Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association</i>
SOP 98-7	<i>Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk</i>
SOP 98-8	<i>Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission</i>



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.93 "AICPA Online," the Institute's Web site ([www.aicpa.org](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. The Web site includes "In Our Opinion," the newsletter of the AICPA Audit and Attest Standards Team. The newsletter provides valuable and timely information on technical activities and developments in auditing and attestation standard setting.

### *CD-ROM Disk*

.94 Practitioners Publishing Company (PPC) and the AICPA are currently offering a CD-ROM disk entitled *The Practitioner's Library—Accounting and Auditing*. This disk includes 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*, and *Peer Review Program Manual*. 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 (888) 777-7077.

.95 This Audit Risk Alert replaces *Real Estate Industry Developments—1997/98*.

.96 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—1998/99* [AAM section 8010] and *Compilation and Review Alert—1998/99* [AAM section 8015] which may be obtained by calling the AICPA Order Department.

.97 The Audit Risk Alert *Real Estate Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with

us. Any other comments that you have about the Alert would also be greatly appreciated. You may email these comments to [GDietz@aicpa.org](mailto:GDietz@aicpa.org) or write to:

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## Appendix

### The Internet: An Auditor's Research Tool

*How can auditors use the Internet to plan and conduct the audit of a real estate entity?*

*What kind of information is available on the World Wide Web?*

*Where can this information be found?*

The Internet contains a vast amount of information that may be valuable to auditors of real estate entities, including—

- Market forecasts and analyses.
- Discussions of current industry trends.
- Benchmarking studies and comparative financial and nonfinancial data.
- Articles and press releases relating to current industry items of interest.
- Links to other real estate Internet sites.

*Audit Risk Alert*—1998/99 [AAM section 8010] contains a list of general auditing and accounting sites. Auditors with clients in the real estate industry also may want to consider the following:

#### ***Organization***

Building Owners and Managers Association  
 Commercial Investment Real Estate Network  
 Institute of Real Estate Management  
 National Association of Real Estate Investment Trusts  
 American Resort Development Association  
 National Council of Real Estate Investment Fiduciaries  
 Real Estate Investment Advisory Council

#### ***Internet Address***

www.boma.org  
 www.ccim.com  
 www.irem.org  
 www.nareit.org  
 www.arda.org  
 www.ncreif.org  
 www.reiac.org

## Information Sources

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Organization	General Information	Fax Services	Web Site Address/ Electronic Bulletin Board	Recorded Announcements
American Institute of Certified Public Accountants	Order Department HARBORSIDE Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	Web site: <a href="http://www.aicpa.org">http://www.aicpa.org</a>	
Financial Accounting Standards Board	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	24 Hour Fax-on-Demand (203) 847-0700, menu item 14	Web site: <a href="http://www.fasb.org">http://www.fasb.org</a>	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)		Web site: <a href="http://www.goa.gov">http://www.goa.gov</a> 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: <a href="http://federal.bbs.gpo.gov">federal.bbs.gpo.gov</a> 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	Web site: <a href="http://www.sec.gov">http://www.sec.gov</a>	

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# AAM Section 8150

## *Retail Industry Developments—1998/99*

### In This Year's Alert . . .

- What are the current economic and industry conditions facing retailers this year?
- Will the Asian crisis have an impact on retail audits this year?
- How are analytical procedures used in the retail environment, and what are some of the more commonly used financial ratios?
- What are some of the audit issues that may arise when considering the collectibility of receivables?
- How does the existence of multiple leased locations affect the auditor of retail entities?
- Is there still a trend toward consolidation and merger in the retail industry, and how does that affect the auditor?
- How has the increasingly competitive environment affected inventory management? How do these changes in inventory management affect the auditor?
- What is the year 2000 issue, and how does it affect retail clients and their auditors?
- How will the impact of Europe's adoption of a new reporting currency affect retailers and their auditors?
- What new auditing and attestation pronouncements have been issued recently?
- What new guidance has been issued with respect to preopening costs?
- What accounting issues arise with respect to store closings?
- How does the retail method work, and what are some of the significant accounting issues when using that method for inventories?
- What recent pronouncements affect the accounting for a retailer's business segments?
- What new accounting pronouncements have been issued recently by the FASB?
- What new AICPA Accounting and Auditing Statements of Position have been issued recently?
- Can auditors use the Internet to perform more efficient audits?

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### Economic and Industry Developments

*What are the current economic and industry conditions facing retailers this year?*

.01 The U.S. economic expansion has continued in 1998, as evidenced by first quarter growth in gross domestic product (GDP) at an annual rate of 5.5 percent. Although second quarter growth was only a 1.8 percent annual rate, it still signaled continued strength in the economy given the expectation of negative growth resulting from the General Motors strike, the rising trade deficit, and a scaling back of plentiful in-

ventories. Third quarter growth is forecast at 2.3 percent, in line with analysts' expectations that the economy would moderate over the second half of the year, with GDP slowing to a 2.0 percent annual rate, as a result of factors such as the recent global turmoil.

.02 High consumer confidence, attributable to factors such as rising personal incomes, low inflation, and low unemployment, led to a boom in consumer spending over the first half of 1998. Consumer spending, a key determinant of retail sales, rose at a 6.1 percent annual rate in the first quarter and a 5.8 percent annual rate in the second, resulting in consumer spending in the first half of the year at nearly twice the rate of the past two years. Nevertheless, consumer confidence has been waning and analysts expect consumer spending to be up at a 3.0 percent to 3.5 percent annual rate in the third quarter, half the results of the first six months.

.03 This increase in consumer spending has benefited retailers, as retail sales are a significant component of consumer spending. After a mildly disappointing 1997 in which retail sales, excluding autos, rose 3.7 percent, consumer spending on retail sales, excluding autos, has continued to climb almost every month in 1998 through September. The one exception was a 0.1 percent decline in June. Nevertheless, it has been difficult for consumers to keep up this pace throughout 1998, as shown by the drop in the annualized increase from 8.0 percent for January through April to 5.2 percent from May through July and small monthly increases in August and September. Analysts had expected a slowdown in retail sales as consumer confidence edged down due to such factors as the moderating economy, international economic problems, and the volatility of the U.S. stock market.

.04 Sales growth should also slow over the next few years due to a general slowdown of the economy and demographic factors, such as an aging population spending more on health care and less on retail items. Consumers may also be spending more on leisure activities, which will increase the competition for the limited time and money available for shopping. Also, the U.S. Bureau of the Census projects a rise of less than 1.0 percent annually in new household formations (that drive many sales of durable household items) over the next decade, as a result of the declining number of Americans in the twenty-five-to-twenty-nine-year age bracket.

.05 One area of uncertainty for the rest of 1998 and 1999 is how the Asian economic crisis will ultimately affect the U.S. economy. According to a recent survey of economists, the U.S. economic expansion will slow next year and GDP will grow at a 2.2 percent rate. The widening trade gap, which has been aided by weaker exports to Asia, is one of the key reasons.

.06 The most prominent effect of the Asian crisis for retailers may be the drop in prices for a number of imported goods and the effect of that drop on inventory valuations. Higher priced inventory items that compete against lower priced imports may not sell as well as expected and the valuation of those inventories as shown on the financial statements may need adjustment. Among the issues auditors need to address are the effects of changes in demand on inventory obsolescence and on inventory valuation under the lower of cost or market rule. For a further discussion of inventory accounting matters for clients using the retail method, including valuation at lower of cost or market, see the section entitled "The Retail Method of Inventory Accounting" in the "Accounting Issues and Developments" section of this Audit Risk Alert. Additionally, other possible audit implications of the developments in Asia can be found in the section entitled "The Crisis in Asia" in the "Audit Issues and Developments" section herein.

.07 One of the ways that auditors obtain audit evidence regarding inventory valuation is through the use of analytical procedures, such as assessing inventory obsolescence by analyzing inventory turnover and reviewing comparisons with industry experience and trends. The importance of analytical procedures, particularly in a retail environment, is discussed in the section entitled "Analytical Procedures" in the "Audit Issues and Developments" section of this Audit Risk Alert.

.08 In addition to potential problems resulting from the situation in Asia, auditors should be aware of other risk factors for the retail industry, such as the proportionally greater number of bankruptcies in the

retail industry as compared to many other industries. Although there has been a slight drop in the level of bankruptcies over the past two years, retailers, particularly individual stores and small chains, are still vulnerable. Most retailers do not have the capital base or cost structure to effectively compete against the retail giants. As such, the auditor needs to be aware of his or her responsibility to evaluate whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to auditors on this issue. Conditions and events that might raise going-concern issues for auditors of retail entities include the following.

- Consumer bankruptcies have continued to rise, although at a declining pace. Revolving consumer credit also continued to advance—by 21 percent in 1995, 12.7 percent in 1996, and 4.7 percent in 1997. There was a flattening in the rate of delinquencies on monthly store-issued credit card balances in 1997, and customers should be able to start paying down credit card balances as a result of a strong job market, falling interest rates, and a slowdown in spending. Still, retailers remain concerned about the high number of consumer bankruptcies. Because consumer bankruptcies directly affect a customer's payment of debts, the effect on the receivables will appear in the allowance made for those customers who will not pay (that is, the allowance for doubtful accounts). A discussion of some of the issues an auditor faces when evaluating the allowance for doubtful accounts is included in the section entitled "Collectibility of Receivables (Allowance for Doubtful Accounts)" in the "Audit Issues and Developments" section of this Audit Risk Alert.
- The overabundance of retail store space is another issue facing the industry. There is still too much retail space for the level of consumer dollars being spent. Given that the cost of maintaining store locations is one of the highest fixed costs for retailers, retailers need to be concerned about how these costs affect profits. The excess amount of retail space has led to the ongoing consolidation, reshuffling, and revamping of store locations. A discussion of how the existence of and changes in numerous locations affect the audits of retailers is included in the section entitled "Multiple Leased Locations" in the "Audit Issues and Developments" section of this Audit Risk Alert.
- Retailers also face the continuing problem of intense competition from the larger retailers who are increasing their market share. There has been significant consolidation in the retail industry among larger entities. Some analysts believe that with a saturated U.S. market, retailers will continue to try to increase profitability by increasing their share of the U.S. market and by global expansion. Although many of the larger mergers have already occurred, business combinations are expected to continue as the large retailers now move to buy the second-tier retailers and grow even bigger. The issues facing auditors of retailers involved in a merger are explored further in the section entitled "Business Combinations" in the "Audit Issues and Developments" section of this Audit Risk Alert.

In this competitive environment, retailers are also facing tight profit margins. In attempting to increase profits, they need to increase sales or to cut costs, and some retailers are using inventory management systems to address one or both of these goals. They are trying to manage inventory more efficiently, which can hold down inventory costs. They may also use their inventory management system to collect sales information that can be used to understand customers better and increase market share. A further discussion of how changes to the client's system of inventory management may affect the auditor is included in the section entitled "Inventory Management" in the "Audit Issues and Developments" section of this Audit Risk Alert.

.09 Some of the issues facing retailers that were discussed in the preceding paragraphs may rise to the level of possible fraud risk factors for a particular client. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), requires that the auditor specifically assess the risk of material misstatement due to fraud on every audit. SAS No. 82 also provides categories of fraud risk factors that the auditor should consider in making the assessment and includes, among other things, examples of fraud risk factors that, when present, might indicate the presence of fraud. Examples of fraud risk factors included in SAS No. 82 that relate to the discussion above include the following:

- Threat of imminent bankruptcy
- Lack of appropriate management oversight (for example, inadequate supervision or monitoring of remote locations)
- High degree of competition or market saturation, accompanied by declining margins
- Adverse consequences on significant pending transactions, such as a business combination, if poor financial results are reported

Numerous other examples are listed in SAS No. 82, some of which may be relevant to many retailers, including large amounts of cash on hand or processed, and inventory characteristics, such as small size, high value, or high demand. When reviewing the environment in which the entity operates and the internal environment of the entity, the auditor should be alert to any situation that might be a fraud risk factor pursuant to SAS No. 82.

#### Executive Summary—Economic and Industry Developments

- Low inflation, low unemployment, and rising personal incomes have led to strong consumer spending and increases in retail sales through the second quarter of 1998.
- Moderation of sales growth, along with the economy, is expected to continue during the latter half of 1998.
- Increasing sales growth does not benefit all retailers equally, and stores continue to address the challenges of high consumer debt levels, an “overstressed” environment, consolidations within the industry, and the need to gain market share.

## Audit Issues and Developments

### The Crisis in Asia

*Will the Asian crisis have an impact on retail audits this year?*

.10 The Asian crisis was one of the most significant economic developments in 1998, and there is continued speculation on how these developments will affect companies, including retailers, in the United States. As discussed in the preceding section, the most likely significant factor for retailers will probably be inventory valuation. If lower cost Asian imports are sold at reduced prices and competing domestic items are sold at higher standard prices, the auditor may need to address the potential risk that the domestic inventory will not sell at the higher price and may not be properly valued at the lower of cost or market. However, in addition to this issue, auditors of retail entities should be aware of other possible effects of the Asian crisis and the related audit and accounting issues, such as the following.

- Retailers with significant export activities curtailed by the Asian crisis may experience declines in the salability of inventory and hence its valuation. Auditors should ensure that such inventories have been properly valued at the lower of historical cost (using an acceptable cost-flow assumption) or market.
- The collectibility of amounts due from troubled Asian entities or from entities with significant reliance on Asian trade may be called into question. Auditors should carefully consider whether management has properly assessed the collectibility of these receivables, as well as whether adequate consideration has been given to possible loan impairment issues pursuant to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text*, vol. 1, sec. 108).
- Going-concern issues may arise for those retailers with significant reliance on Asian trade or for those retailers whose customers have such reliance. Possible areas of concern are when the retailer loses significant sales to less expensive Asian products or when banks are hesitant to lend money to finance



current operations. In such circumstances, auditors should consider the guidance set forth under SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

- Retailers who sell to or buy from Asia may have greater risk associated with foreign currency related transactions. Auditors should consider whether management has appropriately accounted for and made all required disclosures relating to foreign currency translation and transactions arising from the translation of asset and liability positions and revenue and expense transactions in currencies other than the U.S. dollar pursuant to FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60).
- For some retailers, the economic impact of the Asian crisis may result in the presence of fraud risk factors that suggest an increased possibility of misstatements arising from fraudulent financial reporting. For example, to offset losses incurred from a slowdown in sales to Asian customers, a retail entity may resort to the inappropriate acceleration of revenue recognition or the improper deferral of expenses. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, sets forth the auditor's responsibilities concerning fraud in a financial statement audit.
- The economic crisis in Asia may affect the operations of entities in Asia that supply goods to the U.S. These Asian entities may be affected in a manner that results in a lowering of quality standards or delays in shipping. For example, high levels of exports from Asia may affect the ability to provide timely shipments if there is a shortage of shipping capacity. These types of situations could affect the quality of the client's inventory, commitments to customers, sales of seasonal goods, and so forth. Among the possible results is that disputes leading to legal action may arise with customers and suppliers over such matters. Information regarding such issues may point to the existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments, pursuant to SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337).
- The Asian crisis may result in a greater number of risks and uncertainties for the retail entity, particularly with regard to current vulnerability attributable to certain concentrations. Auditors should consider whether management has appropriately evaluated all such risks and uncertainties and made the necessary disclosures pursuant to Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. In addition, auditors should also evaluate management's consideration of related contingencies arising from the Asian crisis, pursuant to FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59).

These examples call attention to some of the possible audit and accounting implications of the Asian crisis, but should not be viewed as an exhaustive list of all the issues that might arise. Auditors should continue to monitor the crisis and carefully assess its impact on their retail clients by considering all relevant facts and circumstances.

## Analytical Procedures

*How are analytical procedures used in the retail environment, and what are some of the more commonly used financial ratios?*

.11 Analytical procedures are required in the planning and overall review stages of the audit according to SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329). In addition, in some cases, analytical procedures can be more effective or efficient than tests of details for achieving particular substantive testing objectives. They may be particularly helpful in a retail setting, where trends tend to remain constant and where the large number of small transactions make it difficult to test a significant portion of the period's transactions. Auditors should be aware of the need to have these procedures performed by staff with the sufficient industry expertise to properly evaluate the results, particularly when analytical procedures are being performed in lieu of other substantive auditing procedures.

.12 In performing analytical procedures, the auditor compares amounts or ratios to expected results developed from such sources as the following:

- Prior period financial information
- Budgets or forecasts
- Relationships among elements of financial information in the same period
- Relationships among financial and nonfinancial data
- Industry data compiled by services (for example, Dun & Bradstreet, Robert Morris Associates, Standard & Poor's)

A brief description of some of the ratios commonly used in a retail environment is given in the following sections.

### ***Liquidity Ratios***

.13 The *acid test ratio (quick ratio)* indicates the retailer's ability to pay current debts using cash and assets that can be quickly converted to cash. It is computed as the total of cash, marketable securities and net receivables, divided by current liabilities.

.14 The *current ratio (working capital ratio)* indicates the company's ability to pay current debts with current assets and is computed as current assets divided by current liabilities.

### ***Financial Leverage Ratios***

.15 The *debt to equity ratio* indicates the extent that the retailer's assets, such as new store locations, are financed with debt rather than equity. It is computed as long-term debt divided by stockholders' equity.

.16 *Times interest earned* is a ratio that indicates the company's ability to meet its debt obligations. It is computed as net income before taxes and interest expense divided by interest expense.

### ***Inventory Valuation Ratios***

.17 The *gross profit ratio* indicates whether profit goals will be met and whether there are unusual variances in cost of sales and inventory, and is computed as gross margin divided by net sales.

.18 The *inventory turnover ratio* indicates how well merchandise inventory is managed and whether sales problems exist. It is computed as cost of goods sold divided by average inventory.

.19 The *stock to sales ratio* indicates the projected time (usually in months) to sell the merchandise. It is computed as beginning merchandise inventory divided by sales for the period. A similar ratio is days of sales in inventory.

.20 *Inventory shrinkage to inventory* indicates the percentage of inventory loss resulting from shrinkage. This ratio is calculated as the inventory shrinkage amount divided by the book value of inventory.

.21 *Net markdowns to inventory available for sale at retail* provides information about trends in marking down inventory. This ratio is calculated as net markdowns divided by total inventory available for sale at retail.

### ***Accounts Receivable Collectibility Ratios***

.22 *Accounts receivable turnover* indicates how well the company collects its receivables and is computed as net credit sales divided by average net accounts receivable.

.23 *Bad debts to net credit sales* indicates whether write-offs are adequate. It is computed as bad debt expense divided by net credit sales.

.24 *Doubtful accounts allowance to accounts receivable* indicates whether the allowance account is adequate. It is computed as allowance for doubtful accounts divided by accounts receivable.

### ***Overall Operating Efficiency Ratios***

.25 The *gross margin return on investment (GMROI)* is a ratio that indicates the profitability of assets and can be calculated at various levels, such as a stock-keeping unit (SKU) or a merchandise department. It is computed as the annual inventory turnover rate multiplied by the markon percentage.

.26 The *return on assets ratio* indicates how well the retailer used assets to generate profits. This ratio is computed as net income divided by average assets.

.27 *Return on equity ratio* indicates the profitability of the capital investment in the company. This ratio is computed as net income divided by average stockholders' equity.

.28 The *return on net sales ratio* indicates the amount of profit generated by each dollar of sales, and is computed as net income divided by net sales.

.29 The *sales per square footage ratio* indicates how well the retailer used selling space, and can be calculated for various levels, such as for the entire company or for a particular store. This ratio is computed as net sales divided by square footage.

.30 The *sales per associate ratio* indicates productivity of sales associates. This ratio is calculated as net sales divided by average number of associates. Similar ratios are sales per employee hour and payroll as a percentage of sales.

.31 The *comparable store sales change ratio* indicates the change in sales for stores that have been open during both the periods being compared and is calculated as the percentage increase in sales from one period to the next only using stores open during both periods.

.32 One area that the auditor may want to consider when reviewing ratios is whether particular ratios must be maintained at a certain level in order to comply with loan agreements. There may be an increased risk of misstatement of accounts that affect those ratios if the company is experiencing financial difficulty.

.33 Also, when reviewing ratios, the auditor may want to compare client-generated information with industry statistics to assess the reasonableness of these financial statement assertions. The auditor may also consider the extent to which a retailer's operations do not match the industry norm. For example, the return on assets ratio will be affected by the extent to which assets are owned or leased, and whether the leases are capital or operating leases. Also, current economic and business environment trends may cause certain historical relationships to no longer be applicable, or they may lag in reflecting current events.

.34 Industry statistics are available from services (for example, *Robert Morris Associates*, *Standard & Poor's*, and *Dun & Bradstreet*). Additionally, the "The Internet—An Auditor's Research Tool" and "Information Sources" sections of this Audit Risk Alert contain the names of several industry associations that may be helpful in obtaining such statistics.

### **Collectibility of Receivables (Allowance for Doubtful Accounts)**

*What are some of the audit issues that may arise when considering the collectibility of receivables?*

.35 With current high levels of consumer bankruptcies, the collectibility of receivables may be a more significant issue this year. The client's estimate of the level of accounts receivable that may not be collectible

as a result of bad debts is reflected in the allowance for doubtful accounts, which is one of the offsets used to bring accounts receivable to their net realizable value. (Other allowances include those for returns and rebates.) An audit of the allowance for doubtful accounts is an audit of an accounting estimate. When auditing estimates, auditors should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements. The guidelines set forth by SAS No. 57 include the following:

- Identification of the circumstances that require accounting estimates
- Consideration of internal control relating to developing accounting estimates
- Evaluating the reasonableness of management's estimate

.36 As part of evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate for the allowance for doubtful accounts and, based on that understanding, use one or a combination of the following approaches listed in SAS No. 57.

1. Review and test the process used by management to develop the estimate.
2. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
3. Review subsequent events or transactions occurring prior to completion of fieldwork.

.37 A review of the aging of the accounts receivable is often performed. This may include testing the reliability of the aging report, reviewing past due accounts on the report, including the number and amount of such accounts, reviewing past due balances, the client's prior history in collecting past due balances, customer correspondence files and credit reports, and so forth. This may be done with the assistance of the client to assist the auditor in obtaining an understanding of how the allowance was developed and determining whether it is reasonable.

.38 Another very useful tool in evaluating the allowance for doubtful accounts is the application of analytical procedures, which was discussed in the preceding section. Often, the large number of customer accounts makes it difficult to determine the adequacy of the allowance only by reference to individual accounts, making analytical review procedures helpful to the audit process. For a further discussion of analytical procedures, see the section entitled "Analytical Procedures" herein.

.39 The auditor may also review revenue and receivable transactions and fluctuations after the balance-sheet date for items such as sales and write-offs. This may provide additional information about the collectibility of the accounts receivable and the reasonableness of the allowance account on the balance-sheet date.

.40 The auditor will, of course, use his or her professional judgment to determine which of these and other procedures to perform to obtain the evidence needed to judge whether the allowance is reasonable.

.41 Also, auditors of retail entities that have transferred receivables should evaluate whether management has properly implemented FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* and FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125 an amendment of FASB Statement No. 125* and any related pronouncement (FASB, *Current Text*, vol. 1, sec. F38).

## Multiple Leased Locations

*How does the existence of multiple leased locations affect the auditor of retail entities?*

.42 Retailers often operate from multiple locations, including stores and warehouses, and these locations can change in response to economic conditions. Retailers often choose to lease a significant portion of their

space, one reason being that leasing, as opposed to owning, frees up capital that can be used in inventory financing. As a result, lease expense is usually one of the larger expense items for retailers. The following discussion highlights some of the variety of leasing issues that the auditor should be alert to when auditing retail clients.

.43 To begin with, the auditor will need to determine the leases that the client has entered into. This may be accomplished with procedures such as talking to company personnel, reviewing minutes, analyzing rent expense (analytical procedures may prove effective for this purpose), and reviewing lease agreements. The auditor should also review the terms of each lease to determine if it has been properly accounted for in accordance with FASB Statement No. 13, *Accounting for Leases*, and the related interpretations and pronouncements (FASB, *Current Text*, vol. 2, sec. L10), which provide, in part, that a lease is categorized as a capital lease if it meets one of the following criteria.

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains an option to purchase the leased property at a bargain price.
3. The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
4. The present value of rental and other minimum lease payments equals or exceeds 90 percent of the fair value of the leased property less any investment tax credit retained by the lessor.

Some of the issues the auditor may encounter when evaluating the lease under these standards are that the lease may only apply to a portion of a building, equipment may be included in the rental, the fair market value of the leased property may not be easily determinable, and the economic life of the leased property may not be easily determinable.

.44 The auditor will need to determine whether the client has properly accounted for the leases in the financial statements and that appropriate disclosures have been included in the financial statements. A detailed discussion of the accounting for lease terms is beyond the scope of this Audit Risk Alert, but in general, for operating leases (which tend to be more prevalent among retail store space), FASB Statement No. 13 provides, in part, the following.

Normally, rental on an operating lease shall be charged to expense over the lease term as it becomes payable. If rental payments are not made on a straight-line basis, rental expense nevertheless shall be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which use benefit is derived from the leased property, in which case that basis shall be used.

.45 In addition to base rents, the lease may provide for various other kinds of lease terms, such as the following:

- Scheduled rent increases
- Rent holidays
- Contingent rents (such as percentage rents)
- Common area maintenance (CAM) charges
- Pass-through charges, such as property taxes and insurance
- Reimbursements by the landlord to the lessee for certain expenses, such as moving and leasehold improvements
- Key money

- Sublease income
- Construction allowances from the landlord for construction or remodeling costs

The auditor will need to determine that these arrangements have also been recorded in accordance with FASB Statement No. 13, and the related interpretations and pronouncements, including consensus positions reached by the FASB's Emerging Issues Task Force (EITF) relating to leasing transactions. See the section entitled "EITF Consensus Positions" in the *Audit Risk Alert—1998/99* [AAM section 8010] for a listing of recent EITF issues, including EITF Issue No. 98-9, "Accounting for Contingent Rent in Interim Financial Periods." EITF Issue No. 98-9 addresses how lessors and lessees should account during interim periods for contingent rental income/expense that is based on future specified targets within the lessor's/lessee's fiscal year.

.46 The auditor should also review leases for upcoming lease expiration dates, penalties for early terminations, requirements that the client make changes to the premises, and other terms.

.47 Lease terms often call for contingent rents to be calculated as the greater of a specified minimum or a percentage of sales over a set dollar amount. Various categories of sales or receipts may be excluded, such as sales to employees, sales taxes collected, and delivery charges. Landlords often require a report from the accountants with respect to the sales amounts. The level of service used in this report can be an audit, a review, a compilation, or agreed-upon procedures. However, the first question to be answered is whether the information will be reported on as supplementary information to the basic financial statements or reported on separately as a separate specified element. Assuming that the landlord requires an audit service, and sales are being reported on as supplementary information, the auditor would follow SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), in addition to other applicable generally accepted auditing standards (GAAS). However, if the audit service is to report on sales as a separate element, the auditor would follow SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), in addition to other applicable GAAS. If a different level of service is required, the auditor would follow the applicable standards.

.48 Numerous other issues can also arise when addressing leases. For example, if the owner of the retail business also owns the building being leased in a separate entity (more often seen with freestanding sites) the auditor should refer to SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 334), and FASB Statement No. 13, and the related interpretations and pronouncements. Another example of a situation the auditor may encounter occurs if the retailer subleases a portion of the stores to independent entities; such arrangements may affect sublease income, payroll, and so forth.

.49 The auditor needs to be aware of various situations that can affect the accounting treatment for the client's leases. For example, due to the nature of the transaction, such as the use of a special purpose entity as the lessor or the client's involvement in asset construction, the retail client may be required to consolidate the other entity or record additional assets. Among the applicable literature are FASB's EITF Issue No. 96-21, "Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities," and EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction."

## Business Combinations

*Is there still a trend toward consolidation and merger  
in the retail industry, and how does that affect the auditor?*

.50 Significant mergers have occurred in the retail industry over the past two decades, particularly among department stores. With many of the biggest mergers completed, the new targets are expected to be the smaller regional players and individual stores sites. Industry analysts anticipate that these consolidations will continue in retailing over the next few years, as retail square footage drops to a more reasonable level. As a result, auditors of retail entities face a greater likelihood of working with clients that were involved in a business combination in the last year and with clients facing an upcoming business combination.

.51 A business combination, according to Accounting Principles Board (APB) Opinion 16, *Business Combinations* (FASB, *Current Text*, vol. 1, sec. B50), occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity that results carries on the activities of the previously separate, independent enterprises. The auditing and accounting issues that arise out of corporate consolidations are numerous and varied. Auditors should carefully consider the individual circumstances of the client to identify those issues and to then develop an appropriate audit strategy. Examples of some of the issues that should be considered by auditors include the following.

- Careful consideration should be given to management's accounting for the business combination to ensure that all relevant GAAP have been considered. For example, if the pooling-of-interests method has been used, have the specific criteria of APB Opinion 16 been met?<sup>1</sup> If not, has the purchase price been allocated to the assets and liabilities acquired with goodwill properly calculated in accordance with the purchase method of accounting? The Securities and Exchange Commission (SEC) has viewed the issue of goodwill with some concern recently and, accordingly, audit risk in this area may be especially acute for publicly held retail entities. Auditors should also be alert to consensus positions reached this year by the FASB's EITF relating to business combinations. See the "EITF Consensus Positions" section of the *Audit Risk Alert—1998/99* [AAM section 8010] for more information.
- Certain items, such as property, plant, and equipment, leases, and identifiable intangibles, may need to be appraised to determine their proper valuation. For example, the intangible assets called *beneficial leaseholds* are normally recorded with the acquisition of a retail entity. These intangible assets result when the unexpired leases that are purchased contain terms more favorable than those that can be obtained in the market. Because these values are generally determined by an outside appraiser, the auditor should refer to the guidance in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).
- With consolidation comes dramatic change in the structure of a retail entity. In an effort to create greater cost efficiencies in the consolidated entity, stores or distribution centers may be combined, and duplicative functions such as purchasing may be eliminated. Auditors should consider the impact of such changes on their client's internal control when making the assessment of control risk. 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS.
- Retailers are increasingly expanding into new product lines and new areas of retailing. For example, a general discounter may acquire supermarket retail stores. This kind of expansion may occur through a business combination and result in a business segment. Such a business combination involving a public business enterprise may result in an operating segment subject to the disclosure requirements of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30). In such circumstances, auditors should consider the guidance set forth under Auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.22). See the "New Auditing and Attestation Pronouncements" section for further information about this Interpretation. Also, a discussion of FASB Statement No. 131 is included in the section entitled "Business Segments" in the "Accounting Issues and Developments" section of this Audit Risk Alert.
- The acquisition of an entity by one party may mean that another party has disposed of a business segment. Accordingly, auditors of the selling party should consider whether management has followed the accounting and disclosure requirements of APB Opinion 30, *Reporting the Results of Op-*

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<sup>1</sup> Accountants, other than the continuing accountant, who have been requested to provide advice on the application of accounting principles to specified transactions, such as whether a proposed business combination is in compliance with the pooling requirements of APB Opinion 16 and other related GAAP, should refer to the guidance set forth under SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625).

*erations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (FASB, *Current Text*, vol. 1, sec. I13). Audit risk may be significant for discontinued operations involving an extended phase-out period. Auditors should give careful consideration to management's estimates when the disposal date of the segment occurs after year-end. SAS No. 57, *Auditing Accounting Estimates*, provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. (For public companies, SEC Staff Accounting Bulletin No. 93 specified that an extended phase-out plan could not extend more than one year beyond the measurement date to qualify as discontinued operations under APB Opinion 30.)

- Business combinations often result in the gain of a client for one auditor and loss of a client for another. The auditor of a retail entity may find himself or herself in the role of either a predecessor or successor auditor. SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance on communications between predecessor and successor auditors if a change of auditors is in process or has taken place.
- Mergers and acquisitions may be effected in part through the use of debt financing. Auditors should carefully evaluate the terms of the debt agreement to identify, among other things, whether there are any loan covenants, and if so, the terms. Auditors should evaluate compliance with restrictive covenants and the implications of any loan covenant violations.
- Subsequent to the business combination, auditors should consider whether management has prepared the financial statements of the combined entity in accordance with appropriate accounting standards including FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FASB, *Current Text*, vol. 1, sec. C51), and Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements* (FASB, *Current Text*, vol. 1, sec. C51).

## Inventory Management

*How has the increasingly competitive environment affected inventory management?  
How do these changes in inventory management affect the auditor?*

.52 In order to increase operating efficiency, retailers are expanding their use of inventory management systems. Retailers are using inventory management systems as an information-gathering tool that can help them to get and keep new customers. Using point of sale systems, retailers are collecting more data on consumer purchases—what, where, and when consumers buy, and which items they buy together. Retailers are then using this information both within the company and with suppliers to decrease out-of-stock situations, improve merchandise flow, and make better buying and marketing decisions. Sophisticated data warehouses not only collect and analyze very detailed information, but are also used as a key decision-enabling tool. This new trend was highlighted in a recent survey, in which most respondents said they had data warehouses up and running for less than a year. The adoption of a new inventory management system by a retail client may raise a number of issues for consideration by auditors, including the following.

- The auditor may be more likely to see prepackaged or customized inventory management systems replacing manual inventory management systems used by their retail clients. In such circumstances, the auditor should evaluate management's consideration of SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. This SOP provides guidance on accounting for the costs of computer software developed or obtained for internal use. See additional discussion of this SOP in the "New AICPA Accounting and Auditing Statements of Position" section of this Audit Risk Alert.
- In order to maintain and update inventory records, a recent survey found that retailers are increasingly using perpetual inventory systems, and cycle counts in addition to full-store inventories, maintaining SKU data in inventory records, and updating inventory records as errors are found, based on exception reports. As retailers make changes to their inventory information systems, audi-



tors will need to consider how these changes affect internal control. If the client is using new procedures, control activities surrounding inventories will have changed. For example, if inventory records are updated on an exception basis, one question concerns who is authorized to input the change. Information available to the auditor and the systems generating that information may also have changed. The auditor may now have information by SKU (a departmental unit) on profit margins or slow-moving inventory. Auditors should consider the impact of such changes on the client's internal control when making the assessment of control risk. 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*, provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS.

- Also, more and more retailers are moving from the retail method of accounting for inventories to the cost method. A likely cause is that the technology needed to maintain and update detailed records is now more readily available. Previously, for example, retailers with a large number of products were likely to use the retail inventory method of accounting, which records inventory at retail prices, because it was too difficult to maintain records at cost. However, the use of computers has made it possible for many retailers to maintain records at cost. Some of the issues auditors face with clients still using retail accounting can be found in "The Retail Method of Inventory Accounting" in the "Accounting Issues and Developments" section of this Audit Risk Alert.
- Since many of the systems used by retailers to record, update, and maintain inventory data are computerized, the auditors of retail companies are increasingly confronted with evaluating evidential matter that may exist only in electronic format. SAS No. 80, *Amendment to SAS No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec 326), provides guidance to auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains, or accesses significant information electronically. Also, a recent AICPA Auditing Procedure Study, *The Information Technology Age: Evidential Matter in the Electronic Environment*, is designed to provide nonauthoritative guidance to auditors in applying SAS No. 80.
- Changes in inventory management may also affect the planning of physical inventory observation. "Inventories" (AICPA, *Professional Standards*, vol. 1, AU sec. 331) discusses the requirement to observe inventories, and the effect of perpetual inventory records, periodic comparisons with physical counts, and inventory controls (including statistical sampling) on the procedures used by the auditor.
- The additional information gathered by a client's computerized inventory management system may also provide data that is useful in performing analytical procedures. For a further discussion of analytical procedures, see the section entitled "Analytical Procedures" herein.

## The Year 2000 Issue

*What is the year 2000 issue, and how does it affect retail clients and their auditors?*

.53 The year 2000 issue relates to the inability of many electronic data processing systems to accurately process year-date data beyond the year 1999. This is attributable to the fact that the majority of computer programs in use today were designed to store dates in the *dd/mm/yy* (date/month/year) format, thus allowing only two digits for each date component. So, for example, the date December 31, 1998, is stored in most computers as 12/31/98. Inherent in programming for dates in this manner is the assumption that the designation 98 refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit-year input fields will cause many computers to treat the entry 00 as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00) as January 1, 1900, and process that data incorrectly, or perhaps not at all.

.54 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year 2000 ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur this year. For example, some software programs have

assigned special meanings to date entries coded *xx/xx/98* or *xx/xx/99*, to allow for the testing of software modifications, and therefore may not process these transactions correctly. Similarly, failures may take place this year when systems perform calculations into or beyond the year 2000.

.55 The significance of these issues to retail clients is that these year 2000 problems, if not remedied, may affect the integrity of systems and information used by retail clients. For example, inventory control systems might treat new items as obsolete, receivables may be erroneously identified as past due, interest calculations may be incorrect, and expiration dates for credit cards could be affected. To further complicate the issue, even if an entity's computer software and hardware have been modified to resolve the problem, the entity may be affected by the computer systems of customers, vendors, or third-party data-processing services that lack such modifications.

.56 Regarding the significance of this issue to auditors of retail clients, it must first be understood that it is the responsibility of an entity's management to assess and remedy the effects of the year 2000 issue on an entity's systems. The year 2000 issue does not create additional responsibilities for the auditor. Under GAAS, 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, regardless of whether the cause is a year 2000 issue or something else.

.57 However, auditors should be aware of the many auditing and accounting issues that arise from the year 2000 issue, including audit planning, going-concern issues, establishing an understanding with the client, valuation, impairment, revenue and expense recognition, and disclosure. A few of these are listed below. A more comprehensive list and discussion of this topic can be found in the *Audit Risk Alert—1998/99* [AAM section 8010].

- Auditors should consider whether the costs associated with their clients' modifications of computer systems pursuant to the year 2000 issue have been properly accounted for. The FASB's EITF has considered this matter in EITF Issue No. 96-14, *Accounting for the Costs Associated with Modifying Computer Software for the Year 2000*, which addresses accounting for the external and internal costs specifically associated with the modification of internal use computer software for the year 2000.
- The year 2000 issue may render certain client assets (such as computer hardware and software) obsolete or inoperable. Accordingly, auditors may wish to consider whether the client has properly accounted for such events by appropriately adjusting useful lives, residual values, or both; or recognizing impairment losses pursuant to the guidelines set forth under FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08).
- The year 2000 issue may create product warranty and product defect liability and product returns issues for software and hardware vendors. These vendors should consider FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 24 to 26, if there are product warranty or product defect liability issues and FASB Statement No. 48, *Revenue Recognition When Right of Return Exists* (FASB, *Current Text* vol. 1, sec. R75) for product return issues.
- Inventories of hardware devices that are not year 2000 ready would be subject to the lower of cost or market test described in ARB 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 4, paragraph 8 (FASB, *Current Text*, vol. 1, sec. I78).
- In addition to the disclosure requirements under the pronouncements previously mentioned, practitioners should be aware of the requirements of SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. Although the need for disclosure by an entity depends on facts and circumstances, disclosure may be required in areas such as impairment, inventory valuation, or litigation if it is reasonably possible that the amounts reported in the financial statements could change by a material amount within one year from the date of the financial statements. Disclosures also may be required

of current vulnerability due to certain concentrations if, for example, a significant vendor has not satisfactorily addressed the year 2000 issue.

- Auditors of publicly held companies should consider the guidance set forth by the SEC in its Interpretation entitled "Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers," (the Interpretation). The Interpretation, which supersedes the guidance previously set forth in the revised Staff Legal Bulletin No. 5, can be viewed on the SEC Web site, <http://www.sec.gov>.

.58 Auditors should also be aware of the risk of litigation relating to the year 2000 issue, as some litigation consultants have indicated that lawsuits against corporate officers, directors, and perhaps auditors will begin before the year 2000 over their failure to recognize and remedy the problem.

.59 A more complete discussion of the implications of the year 2000 issue, along with a list of published guidance in this area, can be found in the *Audit Risk Alert—1998/1999* [AAM section 8010]. Also the AICPA's web site, <http://www.aicpa.org>, provides a year 2000 resource page with additional information and links with other sites, and the AICPA publication "The Year 2000 Issue—Current Accounting and Auditing Guidance."<sup>2</sup>

## Europe's New Reporting Currency—The Euro

*How will the impact of Europe's adoption of a new reporting currency affect retailers and their auditors?*

.60 On January 1, 1999, the European Economic and Monetary Union (EMU) goes into effect. Under the EMU, only one reporting currency will exist—the Euro. From that point on, every entity that trades with or has subsidiaries in Europe will be affected by the change to a common currency.

.61 Under the current system, published currency exchange rates and cross-currency exchange rates are used to convert, for example, the U.S. dollar into the German Deutschmark and the Deutschmark into the French franc, respectively. Under the new system (a process called *triangulation*), the old currencies will continue to exist for a three-and-a-half year transition period, but the only published exchange rates will be that of the Euro. Accordingly, the conversion of U.S. dollars to Deutschmarks will involve an intermediate step—first dollars to Euros using published exchange rates, then Euros to Deutschmarks using official published conversion rates (which will be finalized on December 31, 1998).

.62 The implications for computerized accounting systems are clear. All software designed for the current system will have to be modified to convert, for example, U.S. dollars to Euros (using daily exchange rates), and then to convert the Euro into the national currency, such as the Deutschmark. Although there is uncertainty as to the cost and impact of the EMU on financial information systems, some are predicting that it may be more demanding than the year 2000 issue. In addition, addressing the problem may be difficult, given that a significant level of technology-related resources are now being allocated to resolve the year 2000 issue.

.63 Many U.S. companies have paid little attention to the implications of the Euro—which are numerous and detailed—because they are focusing on year 2000 problems. Accordingly, auditors should consider the increased risks that may be associated with this issue. For auditors of entities issuing calendar year-end financial statements, the impact of the Euro will likely be limited to type II subsequent events that may require financial statement disclosure, as discussed in "Subsequent Events" (AICPA, *Professional Standards*, vol. 1, AU sec. 560).

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<sup>2</sup> With regard to this publication, the SEC Interpretation on year 2000 issues (referred to above) states that "Although the term may be used throughout the AICPA's guidance, perhaps suggesting that the guidance is discretionary, we believe that the procedures outlined by the AICPA should be considered appropriate practice at this time and we expect companies and their auditors to comply with that guidance. If they do not, they should be prepared to justify why the procedures were not followed."

.64 Retailers may be more at risk than other companies this year because many retailers have fiscal year-ends in January and will need to address this issue for their fiscal year ending in 1999 financial statements. Therefore, auditors of retail entities issuing financial statements for fiscal years ending after January 1, 1999, should consider the following:

1. The audit risks that may be associated with management's accounting for foreign-currency transactions involving the Euro
2. Control risk assessment relating to the Euro, such as revamped information systems or changes in foreign operations
3. The fraud risk factors that might arise with the adoption of the Euro, along with the adequacy of financial statement disclosures that may be required in the circumstances

.65 FASB Staff Announcement, Topic D-71, *Accounting Issues Relating to the Introduction of the European Economic and Monetary Union (EMU)*, discusses upgrade costs for projects to adapt information systems software for the Euro, and the preparation of comparative financial statements if there has been a change in reporting currency to the Euro. In addition, the SEC's Divisions of Corporation Finance, Market Regulation, and Investment Management issued Staff Legal Bulletin No. 6, which provides guidance on Euro-conversion-related issues such as the disclosure requirements that could arise.

## New Auditing and Attestation Pronouncements

*What new auditing and attestation pronouncements have been issued recently?*

### New Auditing Standards

#### SAS No. 86

.66 SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634), was issued in March 1998 by the Auditing Standards Board (ASB) to reflect the issuance of SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners that have examined or reviewed MD&A in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

#### SAS No. 87

.67 SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), was issued in September 1998 by the ASB and is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. The SAS states that an auditor should restrict the use of a report if the following occur.

- The subject matter of the auditor's report or the presentation being reported on is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or other comprehensive basis of accounting (OCBOA).
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.

- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

.68 In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used in restricted-use reports, and requires an auditor to restrict a single combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

### **SAS No. 21—Rescinded**

.69 SAS No. 21, *Segment Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 435) contained guidance for auditing disclosures made in accordance with the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 was superseded upon the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30), which is effective for fiscal years beginning after December 15, 1997 with earlier application encouraged. Accordingly, the ASB has rescinded SAS No. 21 effective for audits of financial statements to which FASB Statement No. 131 has been applied. In its place, Auditing Interpretation No. 4 "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter*, has been issued. For a more detailed discussion of the new interpretation, see the section entitled, "New Auditing Interpretations, a New Attestation Interpretation, and New AITF Advisories."

.70 And don't forget the following ASB pronouncements that became effective during 1998:

- SAS No. 83, *Establishing an Understanding With the Client* (Effective for engagements for periods ending on or after June 15, 1998)
- SAS No. 84, *Communications Between Predecessor and Successor Auditor* (Effective for engagements accepted after March 31, 1998)
- SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333) (Effective for audits of financial statements for periods ending on or after June 30, 1998)
- SSAE No. 7, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AT sec. 100) (Effective for engagements for periods ending on or after June 15, 1998)

## **New Attestation Standard**

### **SSAE No. 8**

.71 Issued by the ASB in March 1998, SSAE No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700), provides guidance to a practitioner on the performance of a review or examination of MD&A prepared pursuant to the rules and regulations of the SEC. The presentation of MD&A in annual reports to shareholders and in other documents constitutes a written assertion upon which an attest engagement may be performed. Specifically, SSAE No. 8 provides the following:

- Conditions for engagement performance for both examinations and reviews of MD&A
- Extensive guidance on planning, performing, and reporting on examinations and reviews of MD&A
- A comparison of activities performed for engagements covered by SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), with those performed under SSAE No. 8

SSAE No. 8 became effective upon issuance.

.72 In September 1998, the ASB voted to issue the exposure draft *Amendments to SSAE No. 1, Attestation Standards; SSAE No. 2, Reporting on an Entity's Internal Control Over Financial Reporting; SSAE No. 3, Compliance Attestation* as a final standard. See the "Exposure Draft Issued by the Auditing Standards Board" section of the *Audit Risk Alert—1998/1999* [AAM section 8010] for further information.

### **New Auditing Interpretations, a New Attestation Interpretation, and New AITF Advisories**

.73 Auditing Interpretations are issued by the Audit Issues Task Force (AITF) of the ASB to provide timely guidance on the application of ASB pronouncements. Interpretations are reviewed by the ASB, but are not as authoritative as ASB pronouncements. Nevertheless, a departure from an Interpretation may have to be justified if the quality of a member's work is questioned. Interpretations become effective upon their publication in the *Journal of Accountancy*.

.74 Shown in the following is a summary of a recently issued Auditing Interpretation that was mentioned in the "Audit Issues and Developments" section of this Audit Risk Alert. Summaries of other recently issued Auditing Interpretations, along with recently issued Attestation Interpretations and AITF Advisories can be found in the *Audit Risk Alert—1998/1999* [AAM section 8010].

#### ***Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, Evidential Matter***

.75 Issued in August 1998, the Interpretation replaces rescinded SAS No. 21 by providing guidance for audits of financial statements of entities that have implemented FASB Statement No. 131. The Interpretation suggests procedures that auditors should consider in (1) planning the audit, (2) evaluating whether an entity has appropriately identified its reportable operating segments in accordance with FASB Statement No. 131, and (3) evaluating the adequacy and completeness of management's disclosures about reportable operating segments and related information, including products and services, geographic areas, and major customers. The Interpretation also includes reporting guidance.

#### ***Other New Auditing Interpretations***

.76 The following are discussed in *Audit Risk Alert—1998/1999* [AAM section 8010]:

- Interpretation No. 4 "Audit Considerations for the Year 2000 Issue" of AU Section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311)
- Interpretation No. 1 "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 125" of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336)
- Interpretation No. 3 "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls" of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324)
- Interpretation No. 2 "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341)
- Interpretation No. 3 "Commenting in a Comfort Letter on Quantitative and Qualitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K" of SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 9634)

### ***New Attestation Interpretation***

.77 The following new Attestation Interpretation is discussed in *Audit Risk Alert—1998/1999* [AAM section 8010]: Interpretation No. 1 “Consideration of the Year 2000 Issue When Examining or Reviewing Management’s Discussion and Analysis” of SSAE No. 8, *Management’s Discussion and Analysis*.

### ***New Audit Issues Task Force Advisories<sup>3</sup>***

.78 The following new AITF Advisories are discussed in *Audit Risk Alert—1998/1999* [AAM section 8010]:

- AITF Advisory Concerning Comprehensive Income.
- AITF Advisory Concerning Practice Issues Regarding Language to Permit the Use of Legal Opinions by Auditors (Note that this Advisory was an intermediary document. It was replaced by the amended Interpretation included in the preceding list under the heading “Other New Auditing Interpretations.”)

## **Accounting Issues and Developments**

### **Preopening Costs**

*What new guidance has been issued with respect to preopening costs?*

.79 Despite the overstored environment, retailers, especially the large ones, continue to expand into new areas with new stores. A number of the costs related to the planning and preparation for a new store opening are referred to as *preopening costs*. Industry practice has been to expense many of these costs because they are not incremental or cannot be specifically identified or because of doubts as to whether the store will open.

.80 For costs that are incremental, identifiable, and directly related to a store opening, however, industry practice has also allowed for the deferral and amortization of costs if they are expected to benefit future periods and 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 would rarely extend beyond one year.

.81 However, auditors should be aware of new guidance in this area. In April 1998, AcSEC issued SOP 98-5, *Reporting on the Costs of Start-Up Activities*. This SOP provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred.

.82 The SOP broadly defines start-up activities and provides examples to help entities determine what costs are and are not within the scope of this SOP. This SOP applies to all nongovernmental entities and, except for certain investment companies, is effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements previously have not been issued. Except for certain entities,<sup>4</sup> initial application of this SOP should be reported as the cumulative effect of a change in accounting principle, as described in APB Opinion 20, *Accounting Changes*. When adopting this SOP, entities are not required to report the pro forma effects of retroactive application.

.83 One of the illustrations that is provided in SOP 98-5 refers to retail entities and provides the following example.

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<sup>3</sup> From time to time the AITF issues AITF Advisories to provide nonauthoritative guidance on current developments or recently issued authoritative literature.

<sup>4</sup> Entities that report substantially all investments at market value or fair value, issue and redeem shares, units, or ownership interests at net asset value, and have sold their shares, units, or ownership interests to independent third parties before the later of June 30, 1998, or the date that the SOP is issued should adopt the SOP prospectively.

A retail chain is constructing and opening two new stores. One will open in a territory in which the entity already has three stores operating. The other will open in a territory new to the entity. (Costs related to both openings are treated the same for purposes of this SOP.) All of the stores provide the same products and services. Following are some of the costs that might be incurred in conjunction with start-up activities that are subject to the provisions of this SOP:

- Salary-related expenses for new employees
- Salary-related expenses for the management store opening team
- Training costs and meals for newly hired employees
- Hotel charges, meals, and transportation for the opening team
- Security, property taxes, insurance, and utilities costs incurred after construction is completed
- Depreciation, if any, of new computer data terminals and other communication devices
- Nonrecurring operating losses

The following costs incurred in conjunction with start-up activities are outside the scope of this SOP (as noted in paragraphs .07 and .08):

- Store advertising costs
- Coupon giveaways
- Costs of uniforms
- Costs of furniture and cash registers
- Costs to obtain licenses, if any
- Security, property taxes, insurance, and utilities costs related to construction activities
- Deferred financing costs

.84 Auditors should review this new SOP and its illustrations to assess whether management has properly accounted for preopening costs pursuant to the provisions of SOP 98-5, and that the applicable guidance in other authoritative literature has been followed for those costs that are outside of the scope of this SOP.

## Store Closings

### *What accounting issues arise with respect to store closings?*

.85 Closing particular stores is often a normal part of a retailer's operations. Among the issues to be considered by the auditor are—

- Whether a store closing constitutes an event or change in circumstances that indicates that the carrying amount of an asset in question may not be recoverable. Auditors should evaluate management's consideration of FASB Statement 121, 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 in such circumstances. This Statement 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 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*. Assets covered by APB Opinion 30 will continue to be reported at the lower of the carrying amount or the net realizable value.

- Whether management has properly addressed the requirements of FASB's 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)*. This has been an area of concern by SEC staff. Auditors of SEC registrants should, therefore, pay particular attention to the accrual of estimated liabilities, the criteria necessary to accrue for the costs of the exit plan, and the disclosures that should be provided. In particular, the reasons for such accruals, and the incurrence of the costs which are subsequently charged against such reserves, or the reversals of excess amounts of such liability reserves, should be clearly disclosed.
- Whether the client has properly addressed the requirements of EITF Issue No. 96-9, *Classification of Inventory Markdowns and Other Costs Associated with a Restructuring*, and, for publicly held companies, whether the position of the SEC staff has been followed regarding the classification as a component of costs of good sold for markdowns associated with a restructuring.
- Whether, as a result of the decision to close a store, the client has entered into a lease modification agreement with the landlord, and whether the client has properly addressed the requirements of EITF Issue 95-17, *Accounting for Modification to an Operating Lease*.

## The Retail Method of Inventory Accounting

*How does the retail method work, and what are some of the significant accounting issues when using that method for inventories?*

.86 The primary literature on inventory accounting is ARB 43, *Restatement and Revision of Accounting Research Bulletins*, Chapters 3A and 4 (FASB, *Current Text*, vol. 1, sec. I78), which provides the following summary.

Inventory shall be stated at the lower of cost or market except in certain exceptional cases when it may be stated above cost. *Cost* is defined as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing inventories to their existing condition and location. Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as first-in, first-out; average; and last-in, first-out).

The above-mentioned ARB provides guidance on applying the lower of cost or market rule, and the definition of those terms. For example, footnote 2 explains that in the case of goods that have been written down below cost at the close of a fiscal period, such reduced amounts shall be considered the cost for subsequent accounting purposes.

.87 Retailers generally use one of two methods for determining inventory cost in order to apply the lower of cost or market rule—the cost method or the retail method. Using the cost method, the retailer would keep track of the cost of the various items in inventory and use this information to determine the cost value of the inventory, allocating it between cost of goods sold and ending inventory.

.88 Because it is difficult to maintain cost information for more than a few items but relatively easy to maintain retail information, the retail method is still used by many retailers. Although more and more retailers are moving toward the cost method because it has been made more accessible through the use of computers, many still use the retail method. And auditors need to be familiar with the accounting issues specific to the retail method.

.89 Under the retail method, the cost of goods sold and ending inventory are determined at retail and reduced to cost value by using a cost-to-retail ratio. In order to understand the specifics of how the ratio is developed, the auditor needs to be familiar with the following concepts:

- *Original retail*—The originally assigned selling price
- *Markon*—The difference between the original retail and the retailer's purchase price
- *Markup*—An increase in the selling price over the original retail price
- *Markup cancellation*—A reduction in the markup, but not yet reducing the markon
- *Markdown*—A reduction to the markon
- *Markdown cancellation*—A reversal of the markdown

.90 As an example, if a toy is purchased for \$10 and originally offered for sale at \$15, the markon is \$5. If the price is increased to \$18, the markup is \$3. If the price is then reduced to \$13, the markup cancellation is \$3, and the markdown is \$2. If it is then offered for sale at \$14, the markdown cancellation is \$1.

.91 The proper classification of these changes is important in the retail method because of their effect on the cost-to-retail ratio. Net markups (markups and markup cancellations) are included in determining the ratio, while net markdowns (markdowns and markdown cancellations) are not.

.92 To calculate ending inventory, goods available for sale is determined at cost and at retail. The value at cost is then divided by the value at retail to determine the cost-to-retail percentage. Sales, net markdowns, and shrinkage at retail are then subtracted from goods available for sale at retail to get ending inventory at retail. Ending inventory at retail is then multiplied by the cost-to-retail percentage to get ending inventory at cost.

.93 The starting point for the preceding formula is the determination of goods available for sale at cost and at retail. This is determined by adding, as applicable, beginning inventory, purchases net of discounts, incidental costs, and net markups, but not net markdowns. If net markdowns were deducted from the retail amount of goods available for sale (the denominator in the ratio), the cost-to-retail ratio would be higher. As a result, when this larger percentage is applied to the value of ending inventory at retail, ending inventory at cost would be increased. Therefore, it is customary to include net markups and exclude net markdowns in the calculation of the cost-to-retail ratio, which will result in an ending inventory that should approximate lower of cost or market valuation.

.94 Because the retail method is an averaging method, the results can be distorted when not applied to reasonably homogeneous groups. Factors that can lead to distortion in the calculation of the inventory balance include applying the retail method to a group of products that is not fairly uniform in terms of its cost and selling price relationship and turnover, and applying the retail method to transactions over a period of time that includes different rates of gross profit, such as those occurring during various seasons.

.95 The retail method uses a perpetual inventory system in that the stock ledger records all inventory changes. Among the items recorded are data on purchases (at cost and retail), sales and returns, markups and markdowns, markup and markdown cancellations, sales discounts, shrinkage, and transfers between departments. It is necessary to perform a physical count at year-end to verify the balances and determine shrinkage.

.96 Many retailers use the last-in, first-out (LIFO) retail method. Because items are not specifically identified in the retail method, the dollar value approach, commonly referred to as the retail dollar value LIFO method, is used. This method measures LIFO layers in retail dollars. Price indexes and cost percentages are used to convert from retail to cost, but does not result in an approximation of lower of cost or market valuation. If LIFO is used for tax purposes, it must be used for financial reporting as well.

.97 One of the areas where tax and accounting rules differ is with respect to the capitalization of costs in inventory. EITF Issue No. 86-46, "Uniform Capitalization for Inventory Under the Tax Reform Act of 1986" discusses this issue.

## Business Segments

### *What recent pronouncements affect the accounting for a retailer's business segments?*

.98 As retailers continue to combine and enter into new areas of the retail business and new geographic locations, it is more likely that they will have a business segment that needs to be reported separately. FASB Statement No 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for the way that public business enterprises (such as a public retail enterprise) report information about operating segments in annual financial statements and requires that those retailer enterprises report selected information about operating segments in interim financial reports issued to shareholders. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. This Statement supersedes FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, but retains the requirement to report information about major customers. It amends FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, to remove the special disclosure requirements for previously unconsolidated subsidiaries.

.99 The Statement does not apply to nonpublic business enterprises or to not-for-profit organizations.

.100 The Statement requires that the public retail enterprise report financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments.

.101 The Statement requires that the public retail enterprise report a measure of segment profit or loss, certain specific revenue and expense items, and segment assets. It requires reconciliations of total segment revenues, total segment profit or loss, total segment assets, and other amounts disclosed for segments to corresponding amounts in the retailer's general-purpose financial statements.

.102 The Statement requires that the public retail enterprise report information about the revenues derived from the retailer's products or services (or groups of similar products and services), about the countries in which the retailer earns revenues and holds assets, and about major customers regardless of whether that information is used in making operating decisions. However, the Statement does not require the retail enterprise to report information that is not prepared for internal use if reporting it would be impracticable.

.103 The Statement also requires that the public retail enterprise report descriptive information about the way that the operating segments were determined, the products and services provided by the operating segments, differences between the measurements used in reporting segment information and those used in the enterprise's general-purpose financial statements, and changes in the measurement of segment amounts from period to period.

.104 The Statement is effective for financial statements for periods beginning after December 15, 1997. In the initial year of application, comparative information for earlier years is to be restated. This Statement need not be applied to interim financial statements in the initial year of its application, but comparative information for interim periods in the initial year of application is to be reported in financial statements for interim periods in the second year of application.

.105 Among the other recent changes that the auditor needs to be aware of when addressing business segments are the rescission of SAS No. 21, and the issuance of Auditing Interpretation No. 4 of SAS No. 31, *Evidential Matter*, "Applying Auditing Procedures to Segment Disclosures in Financial Statements." These are discussed further in the "New Auditing and Attestation Pronouncements" section of this Audit Risk Alert.

## New FASB Pronouncements

*What new accounting pronouncements have been issued recently by the FASB?*

### FASB Statement No. 132

.106 In February 1998, the FASB issued Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an amendment of FASB Statements No. 87, 88, and 106* (FASB, *Current Text*, vol. 1, secs. P16, P40). FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statement Nos. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16), 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, sec. P16), and 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40), were issued. FASB Statement No. 132 suggests combined formats for presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

.107 FASB Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

### FASB Statement No. 133

.108 In June 1998, the FASB issued FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50). FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (2) a hedge of the exposure to variable cash flows of a forecasted transaction, or (3) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.109 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.110 For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a *fair value hedge*), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

.111 For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a *cash flow hedge*), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earn-

ings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

.112 For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair value hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.

.113 For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.114 Under FASB Statement No. 133, an entity that elects to apply hedge accounting is required to establish, at the inception of the hedge, the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

.115 FASB Statement No. 133 applies to all entities. A not-for-profit organization should recognize the change in fair value of all derivatives as a change in net assets in the period of change. In a fair value hedge, the changes in the fair value of the hedged item attributable to the risk being hedged also are recognized. However, because of the format of their statement of financial performance, not-for-profit organizations are not permitted special hedge accounting for derivatives used to hedge forecasted transactions. FASB Statement No. 133 does not address how a not-for-profit organization should determine the components of an operating measure if one is presented.

.116 FASB Statement No. 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

.117 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. F60), to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It supersedes FASB Statement Nos. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. FASB Statement No. 133 also nullifies or modifies the consensus reached in a number of issues addressed by the EITF.

.118 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of this Statement should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of this Statement. Earlier application of all of the provisions of this Statement is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of this Statement. This Statement should not be applied retroactively to financial statements of prior periods.

#### **FASB Statement No. 134**

.119 In October 1998, the FASB issued FASB No. 134, *Accounting for Mortgaged-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, an amendment of FASB Statement No. 65.

**FASB Technical Bulletin No. 97-1**

.120 FASB Technical Bulletin No. 97, *Accounting Under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*, provides guidance on accounting for certain employee stock purchase plans under FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FASB, *Current Text*, vol. 1, sec. C36). The bulletin does not address the accounting for those plans under APB Opinion 25, *Accounting for Stock Issued to Employees* (FASB, *Current Text*, vol. 1, sec. C47). The Bulletin applies to stock-based awards granted, renewed, or modified on or after January 1, 1998.

**EITF Consensus Positions**

.121 The status of issues considered recently by the EITF of the FASB can be found in the *Audit Risk Alert—1998/1999* [AAM section 8010].

**New AICPA Accounting and Auditing Statements of Position**

*What new AICPA Accounting and Auditing  
Statements of Position have been issued recently?*

**SOP 97-2 (See SOP 98-4 below regarding deferral of a provision.)**

.122 In October 1997, the Accounting Standards Executive Committee (AcSEC), issued SOP 97-2, *Software Revenue Recognition*. This SOP provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. This SOP supersedes SOP 91-1, *Software Revenue Recognition*. This SOP requires the following:

- 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.
  - Persuasive evidence of an arrangement exists.
  - Delivery has occurred.
  - The vendor's fee is fixed or determinable.
  - Collectibility is probable.
- Software arrangements may consist of multiple elements, that is, additional software products, upgrades/enhancements, 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, services that do not involve significant customization, subscriptions, and arrangements in which the fee is based on the number of copies.
- Vendor-specific objective evidence of fair value is limited to (a) the price charged when the element is sold separately, or (b) if the element is not yet being sold separately, the price for each element established by management having the relevant authority.
- The portion of the fee allocated to an element should be recognized as revenue when all of the revenue recognition criteria have been met. In applying those criteria, the 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, the collectibility of that portion of the fee is not considered probable if the amount of the fees allocable to delivered elements is subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.

- Separate accounting for a service element of an arrangement is required if both of the following criteria are met.
  - The services are not essential to the functionality of any other element of the transaction.
  - The services are described 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.
- 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 (ARB) 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 criteria specified in SOP 97-2 for separate accounting for any service element are met.

.123 This SOP is effective for transactions entered into in fiscal years beginning after December 15, 1997. Earlier application is encouraged as of the beginning of fiscal years or interim periods for which financial statements or information have not been issued. Retroactive application of the provisions of this SOP is prohibited.

## SOP 98-1

.124 In March 1998, AcSEC issued SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. This SOP provides guidance on accounting for the costs of computer software developed or obtained for internal use. It requires the following.

- Computer software costs that are incurred in the preliminary project stage should be expensed as incurred. Once the capitalization criteria of the SOP have been met, external direct costs of materials and services consumed in developing or obtaining internal-use computer software; payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and interest costs incurred when developing computer software for internal use should be capitalized. Training costs and many kinds of data conversion costs should be expensed as incurred.
- Internal costs incurred for upgrades and enhancements that add functionality should be expensed or capitalized using the same criteria as for new software. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.
- External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized using the same criteria as for new software. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.
- Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. I08).
- The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.

- If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, should be applied against the carrying amount of that software.

.125 SOP 98-1 identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use. The SOP applies to all nongovernmental entities and is effective for financial statements for fiscal years beginning after December 15, 1998. It should be applied to internal-use software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of the SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Costs incurred prior to initial application of this SOP, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred.

## SOP 98-4

.126 In March 1998, AcSEC issued SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*. This SOP defers for one year the application of the following passages in SOP 97-2, which limit what is considered VSOE of the fair value of the various elements in a multiple-element arrangement:

- (1) The second sentences of paragraphs 10, 37, 41, and 57
- (2) Example 3 in "Multiple-Element Arrangements—Products" on page 67 (appendix A)
- (3) Example 3 in "Multiple-Element Arrangement—Products and Services" on page 70 (appendix A)

All other provisions of SOP 97-2 remain in effect.

.127 This SOP applies to all multiple-element software arrangements, as defined in paragraph 9 of SOP 97-2, and is effective as of March 31, 1998. If an enterprise had applied SOP 97-2 in an earlier period for financial statements or information already issued prior to the promulgation of this SOP, amounts reported in those financial statements or as part of that information may be restated.

## SOP 98-5

.128 In April 1998, AcSEC issued SOP 98-5, *Reporting on the Costs of Start-Up Activities*. This SOP provides guidance on the financial reporting of start-up costs and organization costs. It requires costs of start-up activities and organization costs to be expensed as incurred.

.129 The SOP broadly defines start-up activities and provides examples to help entities determine what costs are and are not within the scope of this SOP. This SOP applies to all nongovernmental entities and, except for certain investment companies, is effective for financial statements for fiscal years beginning after December 15, 1998. Earlier application is encouraged in fiscal years for which annual financial statements previously have not been issued. Except for certain entities noted in the following paragraph, initial application of this SOP should be reported as the cumulative effect of a change in accounting principle, as described in APB Opinion 20, *Accounting Changes*. When adopting this SOP, entities are not required to report the pro forma effects of retroactive application.

.130 Entities that report substantially all investments at market value or fair value, issue and redeem shares, units, or ownership interests at net asset value, and have sold their shares, units, or ownership interests to independent third parties before the later of June 30, 1998, or the date that the SOP is issued should adopt the SOP prospectively.

## Other SOPs Issued

- .131 The following are discussed in *Audit Risk Alert—1998/1999* [AAM section 8010].



- SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
- SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*
- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*
- SOP 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission*. This SOP has been posted in its entirety on the AICPA Web site <http://www.aicpa.org>.

## The Internet—An Auditor Research Tool

### *Can auditors use the Internet to perform more efficient audits?*

.132 If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to SEC filings, professional news, state CPA society information, Internal Revenue Service information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, free of charge.

.133 A number of resources provide direct information, while others may simply point to information inside and outside of the Internet. Auditors can use the Internet to—

- Obtain audit and accounting research information.
- Obtain texts such as audit programs.
- Discuss audit issue with peers.
- Communicate with audit clients.
- Obtain information from a client's Web site.
- Obtain information on professional associations.

.134 There are caveats to keep in mind when using the Internet. Remember that reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; be cautious when accessing data from unknown or questionable sources. Although there is a vast amount of information available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

.135 Some Web sites that may provide valuable information to auditors are listed in the following table. Additional web sites are shown on in the section entitled "Information Sources," at the end of this Audit Risk Alert.

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Chain Store Age	Industry periodical with retail news headlines	<a href="http://www.chainstorage.com">http://www.chainstorage.com</a>
MRI Retail Search	Executive search firm that provides links to many industry web sites	<a href="http://www.mrisearch.com">http://www.mrisearch.com</a>
Today's Retail News	Current events in the retail industry	<a href="http://www.biz.yahoo.com/news/retail.html">http://www.biz.yahoo.com/news/retail.html</a>
Accountants Home Page	Resources for accountants and financial and business professionals	<a href="http://www.computercpa.com">http://www.computercpa.com</a>
AuditNet	Electronic communications among audit professionals	<a href="http://www.cowan.edu.au/mra/home.htm">http://www.cowan.edu.au/mra/home.htm</a>
CPAnet	Links to other Web sites of interest to CPAs	<a href="http://www.cpalinks.com">http://www.cpalinks.com</a>
Cybersolve	Online financial calculators such as ratio and breakeven analysis	<a href="http://www.cybersolve.com/tools1.html">http://www.cybersolve.com/tools1.html</a>
Double Entries	A weekly newsletter on accounting and auditing around the world	<a href="http://www.csu.edu.au/lists.anet/ADBLE-L/index.html">http://www.csu.edu.au/lists.anet/ADBLE-L/index.html</a>
The Electronic Accountant	World Wide Web magazine that features up-to-the minute news for accountants	<a href="http://www.electronicaccountant.com">http://www.electronicaccountant.com</a>
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	<a href="http://fedworld.com">http://fedworld.com</a>
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory	<a href="http://www.fsforum.com">http://www.fsforum.com</a>
General Accounting Office	Policy and guidance materials, reports on federal agency major rules	<a href="http://www.gao.gov">http://www.gao.gov</a>
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	<a href="http://www.tetranet.net/users/gaostl/guide.htm">http://www.tetranet.net/users/gaostl/guide.htm</a>
Hoovers Online	Online information on various companies and industries	<a href="http://www.hoovers.com">http://www.hoovers.com</a>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.kentis.com/ib.html">http://www.kentis.com/ib.html</a>
U.S. Tax Code Online	A complete text of the U.S. Tax Code	<a href="http://www.fourmilab.ch/ustax/ustax.html">http://www.fourmilab.ch/ustax/ustax.html</a>
Vision Project	CPA tool for Internet sites, discussion groups, and other resources for CPAs	<a href="http://www.cpavision.org/horizon">http://www.cpavision.org/horizon</a>

## Information Sources

.136 Further information on matters addressed herein is available through various publications and services listed in "Information Sources." Many nongovernment and some government publications and services involve a charge or membership requirement.

.137 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 telephone. Most fax services offer an index document, which lists titles and other information describing available documents.

.138 Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communication software. Some bulleting board services are also available using one or more Internet protocols.

.139 Recorded announcements allow users to listen to announcements about a variety of recent scheduled actions or meetings.

.140 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.

.141 Practitioners should also be aware of the economic, industry, regulatory, and professional developments described in *Audit Risk Alert—1998/1999* [AAM section 8010] and *Compilation and Review Alert—1998/1999* [AAM section 8015], which may be obtained by calling the AICPA Order Department at 1-888-777-7077.

.142 The *Retail Industry Developments Audit Risk Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share those with us. Any other comments that you have about the Alert would also be greatly appreciated. You may e-mail to [sfrohlich@aicpa.org](mailto:sfrohlich@aicpa.org), or write to:

Susan Frohlich, CPA—New York  
AICPA  
Harborside Financial Center  
201 Plaza Three  
Jersey City, NJ 07311-3881

## Information Sources

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Organization	General Information	Fax/Phone Service	Electronic Bulletin Board Service	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	Internet address: <a href="http://www.aicpa.org">http://www.aicpa.org</a>	
Financial Accounting Standards Board	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		Internet address: <a href="http://www.fasb.org">http://www.fasb.org</a>	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) 942-4046 SEC Public Reference Room (202) 942-8090	Information Line (202) 942-8088, ext. 3	Internet address: <a href="http://www.sec.gov">http://www.sec.gov</a>	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	Internet address: <a href="http://www.doc.gov">http://www.doc.gov</a> <a href="http://www.bea.doc.gov">http://www.bea.doc.gov</a>	Public Information Office (202) 606-9900
National Association of Retail Dealers of America	10 E. 22nd Street, Ste. 310 Lombard, IL 60148	General Information (630) 953-8950	Internet address: <a href="http://www.narda.com">http://www.narda.com</a>	
National Retail Federation	325 7th St. NW, Ste. 1000 Washington, DC 20004	General Information (202) 783-7971	Internet address: <a href="http://www.nrf.com">http://www.nrf.com</a>	
International Mass Retail Association, Inc.	1700 North Moore Street Suite 2250 Arlington, VA 22209	General Information (703) 841-2300 Fax (703) 841-1184	Internet address: <a href="http://www.imra.org">http://www.imra.org</a>	

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# AAM Section 8160

## *Auto Dealership Industry Developments—1998/99*

### In This Year's Alert . . .

- What is an automobile dealership? What is the most common type of dealership?
- What are the current economic conditions dealerships are facing?
- What competition do dealerships face today that is relevant to audits of dealerships?
- What regulatory issues may be of significance in audits of dealerships?
- What are some of the significant accounting and auditing considerations for dealerships?
- What is the Year 2000 Issue and how will it affect your audits?
- What new auditing pronouncements have been issued over the past two years?
- What new accounting pronouncements have been issued over the past two years?

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### Industry Profile

*What is an automobile dealership?  
What is the most common type of dealership?*

.01 There are many types of dealerships, the most common of which is the automobile dealership. Automobile dealerships generally sell cars, minivans, sport utility vehicles, and light trucks. Other types of dealerships sell boats, heavy trucks, farm machinery, and recreational vehicles. Although this Audit Risk Alert focuses on the automobile dealership, the topics discussed here can be applied to all dealerships.

.02 An automobile dealership is a combination of several separate, but integrated, departments managed as one company. The typical dealership includes the following departments:

- New vehicle sales
- Used vehicle sales
- Finance and insurance (F&I)
- Parts and service
- Body shop
- Lease and rentals
- Administrative

All the departments within the dealership supplement the new car department either directly or indirectly. Often dealerships become involved in the used car market by accepting trade-ins in order to sell new cars.

As a result, they must also dispose of used cars either by selling them at wholesale (via auctions or to other used car lots) or at retail. The trade-in is typically a partial payment for a new car.

## Form of Organization

.03 A dealership may be organized in various forms, depending on the objectives it wishes to meet. For example, if the dealership wishes to shift its tax burden from itself to its owners, it may take the form of a partnership, or S corporation. If the dealership wishes to limit the liability of its owners, it may take the form of a limited liability company, a limited liability partnership, or a corporation. Generally, automobile dealerships are organized as S corporations.

.04 In addition to the form a dealership may take, the type of dealership varies. The most prevalent types of dealerships found today include—

- **Franchised Dealerships.** A vehicle manufacturer gives the dealership the right to market its vehicles through a franchise agreement.
- **Manufacturer-Owned Dealerships.** In response to competition from retail chains and automotive superstores, many manufacturers are selling directly to the public through their own dealerships.
- **Retail Chain Dealerships (Private and Publicly Held).** Retail chains are formed when dealerships are purchased and consolidated by an entity. A new trend in the industry is that of taking the retail chain public.

Franchised dealerships are the most common type of dealership; there are more than 19,500 franchised automobile dealers in the United States. They purchase new vehicles from the manufacturer with whom they have the franchise agreement. The individual franchise agreements determine the specific characteristics of the dealership. Auditors of franchised dealerships should become familiar with the franchise agreement so they can identify those matters that may have accounting or disclosure implications for the dealership. The following list details characteristics common to all franchised automobile dealerships.

- The dealership is franchised by a manufacturer (whether domestic or foreign). The dealership depends on the manufacturer to supply vehicles. The dealership also relies on the manufacturer to maintain and enhance the image of the vehicles it sells.
- Because dealerships invest large amounts of money in vehicle inventory, they are usually highly leveraged. Inventories are generally financed through a special type of credit arrangement, referred to as a *floor plan line of credit*.<sup>1</sup>
- Dealerships operate with narrow gross profit margins and high overhead costs. These result in a high sales break-even point. High volume and fast turnover are key to a dealership's survival.
- Operating expenses, for the most part, are fixed. However, some expenses, such as the costs of preparing cars for delivery and the commissions earned by sales personnel, are variable.
- Sales-related personnel, which include personnel involved in vehicle, parts, and service sales, are generally paid by commission. Salaried employees are generally involved in the administrative aspects of the dealership.

.05 Parts and service departments usually are required under the dealership's franchise agreement and contribute to the profitability of the dealership. In addition to providing customer service, the parts and service department supports the new and used car departments by preparing the vehicles for sale. Dealerships must maintain an adequate stock of parts and accessories.

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<sup>1</sup> A floor plan line of credit is an arrangement with a lender to finance purchases of inventory. Each floor plan note is secured by an individual vehicle. When the vehicle is sold, the related floor plan liability is usually due within three days.

.06 In addition, dealerships can earn a significant amount of income by participating in the financing and leasing of new and used vehicles. Dealerships may also earn insurance commissions from the sale of various insurance products, such as extended warranties, and credit life insurance.

.07 The number of franchised car dealerships has been decreasing at the expense of small-volume dealerships. Although the decline has slowed down considerably since 1990, according to *Automotive Executive Magazine*, in 1987 there were more than 7,000 dealerships with fewer than 150 new vehicle sales per year; today there are fewer than 4,600 such dealerships. In contrast, there are more than 5,700 dealers today that sell more than 750 vehicles per year, whereas fewer than 4,000 dealerships existed in 1987.<sup>2</sup>

.08 During the 1980s the industry witnessed the growth of chain dealerships or “megadealers”. In 1989, 20 percent of all dealerships were part of a chain, whereas in 1983 only 13 percent were. Chain affiliation grew even faster during the early 1990s, reaching 30 percent in 1993. This trend appears to reflect dealers’ desire to achieve greater economies of scale. Furthermore, by offering a broad product line, dealers can reduce their dependence on the success of a particular make and increase their market penetration.<sup>3</sup> The number of dealerships is expected to continue to decline, especially in the wake of the mergers and consolidations happening in the industry. (See the section “Competition” in this Audit Risk Alert.)

## About the Industry

.09 Automobile sales are a big business in the United States. In 1997 alone, total dollar sales of all franchised new car dealerships rose to a record \$508 billion and more than 15 million new cars and light trucks were registered in the United States.<sup>4</sup> In recent years much of the dealership profits have come from the sale of used vehicles and service and parts. New vehicle sales stayed the same in 1997 as 1996, totaling 15.1 million. 1997 used vehicle sales also stayed the same as 1996 sales, totaling 19.2 million.

.10 The demand for leased cars continues to grow. As these cars come off lease they are recycled into the used car market. The National Automobile Dealers Association (NADA) has found that 45 percent of vehicles that come off lease are being returned to the lessor. However, because vehicles are increasingly of better quality and durability, used cars are becoming a good value and are more affordable to the average consumer. Further, as new car prices continue to increase and move beyond the reach of the average consumer, used cars are becoming much more attractive.

.11 A big trend in the industry is the use of auctions as a source of used vehicles. Although 64 percent of used vehicles are still obtained by dealerships through trade-ins, according to the NADA, 28 percent are now obtained through auction; this represents an increase of 10 percent from the early 1980s. Another trend facing the industry is the growth of used car “superstores”. These superstores primarily sell used vehicles that are less than five years old and have low mileage. These superstores also sell their vehicles to shop-at-home consumers through the Internet.

## Economic Developments

### *What are the current economic conditions dealerships are facing?*

.12 Total retail automobile sales mirror the general ebb and flow of the economy. Buying decisions are influenced by a multitude of economic factors, including disposable personal income; consumer confidence;

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<sup>2</sup> Automotive Executive Magazine *NADA Data 1995*, p. 29, and *NADA Data 1998*.

<sup>3</sup> Automotive Executive, *Trendline*, May 1993, p. 10.

<sup>4</sup> Automotive Executive Magazine *NADA Data 1998*.

the relationship between car prices, the rate of inflation and real wage growth; and the availability, cost, and average maturity of consumer credit. No single variable determines how the industry will perform over time. However, there appears to be a strong historical relationship between consumer confidence and automobile sales. In fact, August 1998 saw continued strong sales of new vehicles because of low interest rates and high consumer confidence. Given the interrelationship of automobile sales and the economy, auditors of dealerships will benefit from having an understanding of general economic conditions. The remaining paragraphs in this section are a brief discussion of the current U.S. economy.

.13 The current economic expansion, now in its eighth year, ranks as one of the nation's strongest growth cycles in almost five decades. The economy's impressive performance during 1998 was clearly demonstrated by key indicators<sup>5</sup> such as the following:

- The nation's unemployment rate, which dropped below 4.5 percent, was near its lowest level in almost thirty years.
- Inflation remained low at a modest 2 percent.
- Consumer confidence reached its highest level in years, thus fueling continued spending. In fact, confidence throughout much of the year was so high that Americans spent 96 cents of every dollar they earned.
- Interest rates remained low by historical standards. For example, average mortgage interest rates on 30-year fixed loans fell below 7 percent; the federal funds overnight bank lending rate was cut to 5.25 percent by the Federal Reserve Bank in September.

Economists expect a number of these conditions to continue into 1999, and are thus predicting another year of economic expansion. However, most agree that the pace of growth is likely to moderate.

.14 Despite these favorable conditions and forecasts, the "Asian crisis", as it is commonly called, presents a potential threat to continued domestic growth. The problems in Asia relate to economic instability arising out of the deep and prolonged recessions in countries that include Indonesia, Thailand, South Korea, Singapore, Malaysia, and Japan. Although there is no way to know just how much of an impact the Asian crisis will have on the nation, the general sense is that there is a very real danger of an Asia-induced recession.

.15 The automobile industry is vulnerable to economic swings and therefore is cyclical in nature. Because of this, it may be more meaningful for auditors to apply analytical procedures to industry data or data from other dealerships instead of relying on year-to-year comparisons. Such analytical procedures can provide the auditor with useful insight into the reasonableness of certain financial statement assertions. Auditors may therefore wish to consider the value of analytical tools, such as gross profit as a percentage of sales, when addressing the guidance set forth under Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), which requires the use of analytical procedures in the planning and overall review stages of all audits.

.16 Many manufacturers maintain "composites" by brand of vehicle. Composites are ratios and statistics that dissect the performance of dealers. Auditors may want to ask their clients to obtain the manufacturer composites so that a comparison can be made to the average. It is important to have audit staff with sufficient industry expertise to perform such analysis, particularly when it is done in lieu of other substantive audit procedures.

.17 Another event auditors should be aware of is the recent decline in the stock market. The stock prices of publicly held retail chains have been hit hard by the downturn in the stock market. Auditors should

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<sup>5</sup> Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures*, requires the use of analytical procedures in the planning and overall review stages of all audits. Statistical information of the type shown may be useful to auditors in applying the provisions of SAS No. 56.



consider the pressures management is under when considering matters relating to an entity's business and industry. Specifically, auditors should consider the risk of fraud when auditing clients subject to intense management pressures. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), points out risk factors that may indicate an increased risk of fraudulent financial reporting at an entity. One of the risk factors identified in SAS No. 82 is 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.

.18 When risk factors are identified, professional judgment should be exercised when assessing their significance and relevance (see SAS No. 82 for a list of fraud risk factors). As you assess the risk of material misstatement, keep in mind that the presence of a risk factor should not be considered in isolation, but rather in combination with other risk factors and conditions or mitigating circumstances. Auditors should become familiar with the requirements of SAS No. 82 when considering risk factors in assessing the risk of material misstatement of the financial statements due to fraud.

.19 Events such as strikes, plant closings, layoffs by major companies, and cutbacks on defense spending can adversely affect dealership performance. The General Motors (GM) strike that occurred this year had a negative impact on GM dealerships. Dealerships are dependent on the manufacturer to supply vehicles. Many consumers shied away from GM dealerships because they couldn't get a car equipped exactly as they wanted. Dealerships may have lost a considerable amount of income because of the lack of available vehicles. 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). (See the "Going-Concern Issues" section of this Audit Risk Alert.) In addition, auditors should consider whether management has made appropriate financial statement disclosures of such concentrations in the available sources of supply materials pursuant to Statement of Position (SOP) No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.20 In addition to the national economy, auditors should also consider the local economy and the strength of the brand name. Significant local developments may affect dealership performance. Certain regions may be vulnerable to economic downturns in major local industries. Other regions may be susceptible to various natural disasters. Whenever a dealership operates in an area that is experiencing such economic pressures, new car sales are likely to suffer.

#### Executive Summary—Economic Developments

- August 1998 saw continued strong sales of new vehicles because of low interest rates and high consumer confidence.
- The General Motors strike has had a negative impact on dealerships. Auditors should be aware of their responsibilities pursuant to SAS No. 59.
- In addition to the national economy, auditor's should also consider the local economy.

## Competition

*What competition do dealerships face today that is relevant to audits of dealerships?*

.21 Industry competition continues to intensify, partly because of a rapid rise in new car prices. As a result, consumers have become less brand loyal and increasingly value conscious, demanding better quality and improved features. As noted earlier, the used car superstores are another area of competition to the franchised dealership. One of the largest superstores is considering whether to offer a "house-brand vehicle". With the automobile market as competitive as it is today and with the excess capacity that exists globally, it is likely this will happen. It is also possible that it will be auto makers from South Korea who will produce

the house-brand vehicle. As it is, the superstore has already changed the way consumers buy used cars by offering no-haggle one-price shopping. In addition, dealerships face increasing competition from Internet shopping and the recent surge of publicly traded companies.

.22 Auditors should be aware of SAS No. 82, which indicates that the presence of a high degree of competition or market saturation, accompanied by declining margins, may indicate an increased risk of fraudulent financial reporting. When fraud risk factors are present, auditors should exercise professional judgment when assessing their significance and relevance.

.23 Auditors should also consider SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), which states that when planning an 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 auditor.

.24 Overcapacity in the automobile industry is a problem globally, and it appears that U.S. and European car makers are finding it advantageous to consider combining. Many manufacturers will consider combining to increase operating and market efficiencies. It is believed that, because of overcapacity and stiff competition, the number of manufactures will significantly decrease over the next ten years. During 1998 a number of merger talks have taken place among automobile manufacturers, resulting in aborted take-over deals as well as successful ones. With the manufacturers consolidating, the number of franchised dealerships is expected to continue to decline. In May 1998, Chrysler and Daimler-Benz announced intentions to merge. The merger will enable Chrysler to gain access to the European markets; similarly, Daimler-Benz now will be able to increase its hold in the American market.

.25 This merger is just one in a trend wherein the major players in the automobile industry are combining forces. At the end of July, BMW purchased the Rolls-Royce brand name. Earlier, BMW held talks with Rolls-Royce that ended unsuccessfully. BMW lost the bidding for Rolls-Royce to Volkswagen (VW), who purchased Rolls-Royce Motor Cars, Ltd. VW, however, failed to purchase the Rolls-Royce brand name. Speculation now exists as to whether VW and BMW will forge some form of alliance in the future. In a further bid to consolidate, VW was also reported to have held talks with Volvo. Although the consolidation of the big car manufacturers may not have an immediate impact on dealerships, the consolidation by manufacturers may cause the number of dealerships to continue to decline as more and more cars are sold by the same dealers.

.26 Another trend facing the industry is the purchasing of independent dealerships by publicly held retail chains. One area of concern to the Securities and Exchange Commission (SEC) is that of the allocation of purchase price to acquired dealerships, in particular the valuation of all assets acquired and the recognition and disclosure of any liabilities recognized in connection with the acquisition (see Emerging Issues Task Force [EITF] Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*). (For a further discussion of this issue, see *Audit Risk Alert—1998/99* [AAM section 8010].)

#### Executive Summary—Competition

- Used car “superstores” offer stiff competition to franchised dealerships.
- Automobile manufacturers are continuing to consolidate.
- Independent dealerships are being purchased by publicly held retail chains.

## Regulatory Environment

*What regulatory issues may be of significance in audits of dealerships?*

.27 Certain environmental and Occupational Safety and Health Administration (OSHA) regulations, as well as particular Internal Revenue Code (IRC) sections, are of particular importance to the industry. State

and local regulations generally fall into four categories: (1) environmental (see the section “Environmental Remediation Liabilities”, (2) taxation, (3) vehicle registration, and (4) business practices.

.28 For example, under California’s clean air rules, beginning this year, at least 2 percent of the cars sold in the state must emit no harmful exhaust emissions. The minimum rises to 5 percent in 2001 and 10 percent in 2003. Currently, the only cars available to consumers that have no harmful exhaust emissions are battery-powered vehicles. Car manufacturers are continuing to research alternative methods to power vehicles without emitting harmful exhaust. Toyota is already selling a battery-powered RAV4. Similarly, GM has the EV1 electric car on sale in limited markets. Many manufacturers, including Daimler-Benz, Toyota, and GM, are working on developing alternative power sources. The main form being tested uses fuel cells.

## Audit Issues and Developments

*What are some of the significant accounting and auditing considerations for dealerships?*

### The Need for an Audit

.29 As part of the franchise agreement, dealerships usually are required to submit timely operating statements on the manufacturer’s prescribed forms; however, manufacturers usually do not require dealerships to have such operating statements audited, reviewed, or compiled by independent accountants. Generally, the outside creditor is the one to require independent accountant involvement. Because auto dealerships usually finance the purchase of new vehicles through a “floor plan line of credit,” the related floor plan agreement usually requires the dealership to submit annual audited or reviewed financial statements. As the industry continues to consolidate, more and more independent dealerships are being purchased by publicly held retail chains or are considering going public themselves. As such, these dealerships may be subject to the Securities and Exchange Commission’s requirements for audited financial statements.

.30 Often creditors will accept reviews or compilations in lieu of audited financial statements. If doing a review or compilation, auditors should look to the Statements on Standards for Accounting and Review Services (SSARS) for guidance.

### Common Users of Auto Dealership Financial Statements

.31 The following list includes the primary users of auto dealership financial statements.

- Manufacturer/franchisor
- Management/owner
- Lenders
- Insurance companies and bonding companies

### Inventory

.32 Vehicle inventory is usually the most significant asset on the balance sheet of an auto dealer. Auditors should be alert to the potential for a high level of audit risk associated with this area.

.33 Audit risk relating to vehicle inventory usually involves issues such as—

- **Proper Cutoff of Sales and Purchases Transactions.** Transactions occurring near yearend should be examined to ensure that they are recorded in the period in which the related revenue has been earned

or the expense incurred. Procedures that may be performed by the auditor to assess the proper cutoff of sales and purchase transactions (see the completeness assertion in SAS No. 31 [AICPA, *Professional Standards*, vol. 1, AU sec. 326.03]) include the observation of physical inventory counts, analytical procedures comparing the relationship of inventory balances to recent purchasing and sales activities, and testing the client's cutoff procedures for shipping, receiving, sales, and purchases.

- **Inventory Valuation.** All inventory should be measured at the lower of cost or market. Any reduction to market becomes the subsequent cost basis pursuant to ARB 43, chapter 4. New vehicles are generally valued at cost to the dealership. The items included in cost vary by manufacturer; for example, some manufacturers establish the cost of new vehicle inventory as factory invoice amount plus internal selling price of dealer add-ons less any holdbacks, nonrelated items such as supplemental advertising, and factory price reductions. Other manufacturers simply price the new vehicle at factory base price, plus factory-installed options, freight, and dealer association advertising charges. Auditors can test new vehicle inventory valuations by examining manufacturers' invoices.

Used vehicle inventory is usually valued at the lower of cost or estimated wholesale value. Cost represents the actual cost of the vehicle when it is purchased. When the vehicle is acquired in a trade-in in conjunction with a new or used vehicle sale, the appraised value is used as cost. Auditors usually can test used vehicle inventory valuations by referencing to published valuation guidelines, such as *Black Book* or NADA publications. Auditors may also assess the value of used vehicles by running a "subsequent sales test" to see if the used vehicles are truly reported at the lower of cost or market. Since used vehicles are usually sold quickly, a meaningful test could be run within thirty days after yearend.

Dealerships typically value their parts and accessories inventories at replacement cost. Because this method is a departure from generally accepted accounting standards (GAAP), auditors of dealerships should consider the effect of this misstatement on the financial statements and on their report. SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.35-.60), describes the circumstances that may require a qualified or adverse opinion when the financial statements contain a departure from GAAP. 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.

Dealerships often use the last-in, first-out (LIFO) inventory method to determine ending inventory and cost of goods sold. By using LIFO, dealerships can significantly reduce their taxable income. (See the "Tax Issues" section of this Audit Risk Alert for a further discussion on LIFO inventory issues.)

- **Inventory Ownership.** Failure to determine ownership can result in the overstatement of inventory through, for example, improper sales or purchase cutoff or incorrect assessment of when a 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 SAS No. 31 [AICPA, *Professional Standards*, vol. 1, AU sec. 326.03]), include—
  - Observing physical inventory counts.
  - Obtaining confirmation of inventories at locations outside the entity.
  - Testing cutoff procedures relating to purchases and sales, as well as examining paid vendors' invoices, shipping terms, consignment agreements, and bill and hold arrangements.
- **The Physical Existence of Vehicle 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 SAS No. 31 [AICPA, *Professional Standards*, vol. 1, AU sec. 326.03]) may include observation of the client's physical inventory count and obtaining confirmation of inventories at lo-

cations outside the entity, along with the testing of inventory transactions between a preliminary physical inventory date and the balance sheet date. Auditors may also consider communicating with the various floor plan institutions with which the dealership operates. Usually, such institutions will perform periodic, surprise inventory checks throughout the year. Auditors may want to inquire if there were any problems found with those inventory checks.

## Finance and Insurance Income

.34 When the dealership provides the customer with financing and the note is sold to a financial institution, that institution generally pays the dealership a fee. If a customer prepays or defaults on the note, the financial institution charges back a portion of the fee to the dealership.

.35 In determining when a dealership should recognize financing income, auditors should assess management's consideration of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (FASB, *Current Text*, vol. 1, sec. F38). FASB Statement No. 125 requires that a transfer of financial assets in which the transferor surrenders control over those assets should be accounted for as a sale to the extent that consideration other than beneficial interest in the transferred asset is received in exchange. The transferor has surrendered control over the 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. (In other words, the contract is beyond the reach of the dealership and its creditors, even in bankruptcy.)
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.

.36 In February 1998, the Audit Issues Task Force (AITF) issued an Interpretation of SAS No. 73, *Using the Work of a Specialist*. The Interpretation, "The Use of Legal Interpretations as Evidential Matter to Support Management's Assertion that a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 125," provides guidance regarding the use of a legal specialist's findings as audit evidence to support management's assertion that a transfer of financial assets meets the legal isolation criterion of paragraph 9(a) of FASB Statement No. 125. The Interpretation addresses when the use of a legal specialist's work may be appropriate; factors that should be considered in assessing the adequacy of the legal response; and the use, as audit evidence, of legal responses that are restricted to the client's use. The Interpretation is effective for auditing procedures related to transactions required to be accounted for under FASB Statement No. 125 that were entered into on or after January 1, 1998. The AITF has amended the Interpretation to include the form of letter that adequately communicates permission for the auditor to use the legal specialist's opinion for the purpose of evaluating management's assertion as well as sample language that does not adequately communicate such permission. The amended Interpretation appeared in the October 1998 issue of the *Journal of Accountancy*.

.37 A new trend emerging in the F&I area includes financing for high-credit-risk customers, commonly referred to as *subprime loans*. Subprime loans are usually high-risk, high-yield loans offered to customers that would not qualify for traditional loans. There are many financial institutions that specialize in subprime loans. Because the majority of these loans are sold to the financial institution specializing in subprime loans,

the dealership itself has no exposure to audit risk. However, if the dealership were to enter into subprime lending itself or undertake certain obligations in case of customer default, this would then become an area with a high level of audit risk.

.38 Dealerships may also earn insurance commissions from the sale of various insurance policies, such as collision and extended warranty. When insurance policies are canceled, the dealership is generally charged back a portion of the commission income. Auditors should consider testing the adequacy of the reserves for future chargebacks through analysis of historical data and application of analytical procedures to develop independent expectations of management's estimates. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.

## Other Issues

### *Repossession Losses*

.39 Dealerships may finance a customer's purchase of new automobiles and, in such instances, they usually sell the related notes to financial institutions. Repossession losses arise from customers' failure to pay notes taken to finance their vehicle purchases. Even when the dealership sells the related notes to a finance company, the dealership may still have to recognize repossession losses if the dealership retains some of the nonpayment risk (recourse). Paragraph 83 of FASB Statement No. 125 says that, if certain criteria are met, a transfer with recourse shall be accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation. In certain cases, the dealership must estimate the uncollectible loans and create a reserve. SAS No. 57 provides auditors with guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit.

### *Notes Payable Under Floor Plan Arrangements*

.40 A floor plan line of credit is an arrangement with a lender to finance purchases of inventory. Each floor plan note is secured by an individual vehicle. When the vehicle is sold, the related floor plan liability is usually due within three days. Auditors should consider confirming such notes with the lender. Auditors should pay particular attention to issues dealing with collateralization and valuation of the underlying inventory and with timely payment of the notes. In addition, it is important for auditors to consider internal controls over matching specific inventory owned to the specific vehicles collateralizing the floor plan financing to assure the dealer isn't "out of trust."<sup>6</sup>

## Leased Vehicles

.41 Dealerships sometimes lease vehicles rather than sell them. In most cases, a leased vehicle is treated as a typical sales transaction because the dealership does not maintain the lease but transfers it to a manufacturer's financing subsidiary. The dealership records a sale to the financing institution and the financing institution obtains a vehicle subject to a lease and the responsibility to account for the lease transaction.

.42 Dealerships may, however, retain vehicle leases rather than transferring them. Dealerships may lease new vehicles under either a sales-type lease or an operating lease. When a long-term lease meets the criteria established by FASB Statement No. 13, *Accounting for Leases* (FASB, *Current Text*, vol. 1, sec. L10), the leasing transaction is treated as a sale. For the leasing transaction to be treated as a sales-type lease, the following conditions should be met.

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<sup>6</sup> An "out of trust" situation occurs when the dealership sells a vehicle but does not pay the related floor plan obligation.

.43 First, at least one of the following four conditions must exist:<sup>7</sup>

1. The lease transfers ownership of the vehicle to the customer by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease term is equal to at least 75 percent of the vehicle's estimated economic life.
4. At the beginning of the lease term, the present value of the minimum lease payments (excluding executory costs) is at least 90 percent of the fair value of the vehicle.

.44 Second, the lease must fulfill both of the following criteria:

1. Collectibility of the minimum lease payment is reasonably predictable.
2. No important uncertainties, such as guarantees against obsolescence, surround the amount of unreimbursable costs yet to be incurred by the auto dealer.

If the lease meets these criteria, it is treated as a sale by the dealership. Auditors may wish to select a sample of the new leases and review the lease agreement. Auditors may also wish to understand all relevant terms of the lease agreement and carefully evaluate them to ensure that management has properly accounted for the transaction, including the calculation of receivables and interest income. Further, auditors may consider confirming the principal balance with the lessee.

.45 Many leases establish a mileage charge in addition to the minimum lease payments. These are considered contingent payments under FASB Statement No. 13 and are not considered in the minimum lease payments. Accordingly, they do not enter into the calculation of the sales price of a sales-type lease. Instead, they are recognized when they are determined to be receivable. FASB Statement No. 13 requires that the total contingent rentals included in income be disclosed in the financial statements. (See EITF Issue No. 98-9, *Accounting for Contingent Rent in Interim Financial Periods*, for guidance on how lessors and lessees should account during interim periods for contingent rental income that is based on future specified targets within the lessor or lessee's fiscal year.)

.46 Dealerships may also enter into operating leases as well. Some of these are long-term leases that do not meet the criteria established in FASB Statement No. 13 for sales-type leases. Others are short-term rentals done for the benefit of customers whose vehicles need repair.<sup>8</sup> In these cases rental revenue is recognized as it is earned. Many floor plan arrangements allow the dealer to pay off a portion of the debt (for example, 2 percent) every month for these vehicles.

.47 For operating leases, auditors should consider whether management has made all disclosures required by FASB Statement No. 13.

## Environmental Remediation Liabilities

.48 Auto-dealerships face issues such as storing and disposing of gas, oil, and batteries. In addition, many dealerships have underground storage tanks that are being removed, either voluntarily by the dealership or because of leakage. SOP 96-1, *Environmental Remediation Liabilities*, provides accounting guidance for the recognition, measurement, display, and disclosure of environmental remediation liabilities. SOP 96-1 requires that environmental remediation liabilities be accrued when the criteria in FASB Statement No. 5,

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<sup>7</sup> The third and fourth conditions do not apply if the lease is entered into during the last 25 percent of the vehicle's estimated economic life.

<sup>8</sup> The same accounting is usually used for loaners except that there is no rental revenue. Many dealerships include loaners under inventory in their financial statements.

*Accounting for Contingencies*, are met. SOP 96-1 includes benchmarks to aid in the determination of when an entity is identified as a potentially responsible party (PRP) and when a feasibility study is completed. SOP 96-1 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. 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.

.49 SOP 96-1 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, SOP 96-1 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.

.50 The Environmental Issues Task Force of the Auditing Standards Board (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 appendix C, "Auditing Environmental Remediation Liabilities", of SOP 96-1.

.51 SOP 96-1 applies when there is the probability of litigation. What should auditors do when the dealership decides to voluntarily remove an underground tank? Auditors should consider whether management has followed the guidance set forth in FASB Statement No. 5, *Accounting for Contingencies*, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and EITF Issue No. 93-5, *Accounting for Environmental Liabilities*.

.52 The FASB Emerging Issues Task Force determined, in EITF Issue No. 93-5, that the liability should be considered separately from any potential recovery from other potentially responsible parties. The loss arising from the recognition of the environmental liability should be reduced only when a claim for recovery is probable of realization. The balance sheet liability should not be offset by a recovery receivable unless the right of offset exists under FASB Interpretation No. 39, *Offsetting Of Amounts Related to Certain Contracts*.

## OCBOA Financial Statements

.53 Auto dealerships sometimes present their financial statements on the tax basis of accounting, which is an other comprehensive basis of accounting (OCBOA). Dealers may choose this basis because it is more relevant to them than GAAP or because they want to avoid the more onerous GAAP disclosures and calculations.

.54 SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), establishes presentation and disclosure principles for the tax basis of accounting, as well as for the cash and modified cash bases. SAS No. 62 requires that—

- The summary of significant accounting policies discuss the basis of presentation and describe how that basis differs from GAAP, although the differences need not be quantified.



- The financial statements contain adequate disclosure. When the financial statements contain items that are the same as, or similar to, those in GAAP financial statements, similar disclosures are appropriate. Thus, disclosures regarding depreciation, long-term debt, and owner's equity should be similar to disclosures made in GAAP financial statements. Also, disclosure should be considered for items such as related-party transactions, restrictions on assets, subsequent events, and uncertainties.

.55 In January 1998, the AITF issued an Interpretation to SAS No. 62. The Interpretation, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting", appeared in the January 1998 issue of the *Journal of Accountancy*.

.56 The Interpretation applies to cash, modified cash, and income-tax-basis presentations. It addresses the summary of significant accounting policies; disclosures for financial statement items that are the same as or similar to those in GAAP statements; issues relating to financial statement presentation; and disclosure of matters not specifically identified on the face of the statements. The Interpretation contains examples of how OCBOA disclosures, including presentation, may differ from those in GAAP financial statements.

.57 The Interpretation states that the discussion of the basis of accounting needs to include only the significant differences from GAAP and that quantifying differences is not required.

.58 If cash, modified cash, or income-tax-basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements either should provide the relevant GAAP disclosure or provide information that communicates the substance of that disclosure. Qualitative information may be substituted for some of the quantitative information required in a GAAP presentation. GAAP disclosure requirements that are not relevant to the measurement of the element, account, or item need not be considered.

.59 Cash, modified cash, and income tax statements should comply with GAAP requirements that apply to the presentation of financial statements or provide information that communicates the substance of those requirements. The substance of GAAP presentation requirements may be communicated using qualitative information and without modifying the financial statement format. Several examples illustrate how this guidance may be applied.

.60 Finally, if GAAP would require disclosure of other matters such as contingent liabilities, going concern, and significant risks and uncertainties, the auditor should consider the need for the disclosure or disclosures that communicate the substance of those requirements. Such disclosures need not include information that is not relevant to the basis of accounting.

.61 For further guidance on OCBOA financial statements see the AICPA's Practice Aid *Preparing and Reporting on Cash- and Tax- Basis Financial Statements* (Product No. 006701).

## Tax Issues

.62 Franchised automobile dealers are normally required to issue monthly income statements to their franchisor, who is also typically a creditor of the dealership. These monthly statements are often prepared in a format required by the franchisor or on a preprinted form supplied by the franchisor. The twelfth-month statement is normally issued within a few days after the end of the year, and presents the dealership's operating results for both the month and the calendar year. It is subsequently amended by another income statement commonly known as the thirteenth-month statement.

.63 For several years, there was uncertainty about whether certain monthly income statements issued to the franchisor/creditor violated the LIFO conformity requirement of IRC section 472(c) or (e)(2). In 1997, the

Internal Revenue Service (IRS) issued guidance to assist auto dealers in determining whether they had violated the LIFO conformity requirement (Revenue Ruling 97-42). In addition, the IRS also issued guidance to forgive certain LIFO conformity violations by auto dealers that occurred on or before October 14, 1997 (Rev. Proc. 97-44).

.64 Revenue Ruling 97-42 provides that an auto dealer has violated the LIFO conformity requirement by providing the credit subsidiary of its franchisor with a twelfth-month income statement (in the format required by the franchisor or on preprinted forms supplied by the franchisor) for the tax year, if that statement fails to reflect the LIFO inventory method in the computation of net income. The ruling provides that an auto dealer has not violated the LIFO conformity requirement if the twelfth-month income statement issued to the credit subsidiary of its franchisor uses the LIFO inventory method to determine net income for both the twelfth-month and for the entire year (even if the LIFO adjustment is only a reasonable estimate.) The LIFO adjustment can either be made against cost of goods sold (so that it is reflected in gross profit) or as an adjustment below the line (so that it is reflected in net income). The IRS may feel that the use of a constant LIFO reserve throughout the year is not a reasonable estimate when the dealer is not on a calendar year basis.

.65 Auto dealers could have received relief under Revenue Procedure 97-44 for prior LIFO conformity violations; however, the relief did not apply to all prior conformity violations. The settlement amount was due by May 31, 1998.

.66 An auto dealer not making a settlement payment should take steps to fully document the fact that it is not required to make such a payment. Copies of all available monthly and annual income statements issued during the look-back period (of six years) should be retained, as well as any other evidence to document when and to whom statements were issued.

.67 In the future, auto dealers should make certain that they comply with the LIFO conformity rules of IRC section 472, as well as Revenue Ruling 97-42, for all income statements issued currently and in the future to shareholders and creditors.

.68 Auditors should be aware of the issue of conformity violations thus far discussed. If an auto dealership has violations and has failed to use the relief that expired on May 31, 1998, the IRS can terminate the dealership's LIFO election and the income tax owed would become due immediately, plus interest and penalties which, in most cases, will be substantial.

.69 IRS Rulings and Procedures that apply include—

- IRS Revenue Procedure 97-36, which supersedes IRS Revenue Procedure 92-79 and is effective as of August 18, 1997. Revenue Procedure 92-79 specified the LIFO inventory valuation approach and standardized the LIFO calculation for new vehicles. The alternative method discussed in Revenue Procedure 97-36 is the same as the method in 92-79 and therefore may not significantly change what dealerships do.
- IRS Revenue Ruling 97-42, which provides guidance to assist auto dealers in determining whether they have violated the LIFO conformity requirements.
- IRS Revenue Procedure 97-44, which gives special relief for certain LIFO conformity violations as long as the action was taken by May 31, 1998. The NADA also issued guidance in this area in its publication *A Guide to the LIFO Conformity Settlement*.

## Going-Concern Issues

.70 Dealership operating losses can accumulate quickly when sales decline, but dealership expenses remain relatively fixed. Extended declines can raise going-concern issues. As noted earlier in the "Economic

Developments” and “Competition” sections of this Audit Risk Alert, automobile dealerships are currently facing stiff competition, consolidations of both manufacturers and dealerships, and overcapacity. Accordingly, auditors should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about a dealership’s ability to continue as a going concern.

.71 Accordingly, auditors should be aware of their responsibilities pursuant to SAS No. 59. SAS No. 59 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.

.72 Continuation of an entity as a going concern usually is assumed in the absence of significant information to the contrary. Such contrary information 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 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.

.73 If, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the dealership’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.

.74 The following list contains some conditions or events that may raise a question about an auto dealerships ability to continue as a going concern:

- Recurring operating losses
- Working capital deficiencies
- Default on loans or similar agreements, including an “out of trust” situation
- Restructuring of debt
- Substantial dependence on the success of a particular project
- Legal proceedings, legislation or similar matters that might jeopardize a dealership’s ability to operate
- Loss of a key franchise, license, principal customer or supplier

#### **Executive Summary—Audit Issues and Developments**

- Some areas of concern when auditing dealerships include inventory, finance and insurance income, leases, environmental activities, OCBOA, and LIFO conformity rules.

## The Year 2000 Issue

### *What is the Year 2000 Issue and how will it affect your audits?*

.75 The Year 2000 Issue relates to the inability of many electronic data processing systems to accurately process year-date data beyond the year 1999. This is due to the fact that the majority of computer programs in use today were designed to store dates in a date/month/year (dd/mm/yy) format, thus allowing only two digits for each date component. For example, the date December 31, 1998, is stored in most computers as 12/31/98. Inherent in programming for dates in this manner is the assumption that the designation "98" refers to the year 1998. Initially developed as a cost-saving technique, this long-standing practice of using two-digit year input fields will cause many computers to treat the entry 00 as 1900. Therefore, such programs will recognize the date January 1, 2000 (01/01/00), as January 1, 1900, and process that data incorrectly or not at all.

.76 There are other possible complications as well. The year 2000 is a leap year. Systems that are not year-2000-ready may not register the additional day, thus producing incorrect results for date-related calculations. In addition, certain year 2000 problems may occur in 1998 or 1999. For example, some software programs may have assigned special meanings to entries date coded as "XX/XX/98" or "XX/XX/99" to allow for the testing of software modifications. Therefore actual transactions using such dates may not be processed correctly or stop functioning. Failures may also take place in 1998 or 1999 when systems perform calculations into or beyond the year 2000.

.77 Unless these year 2000 problems are remedied, significant problems relating to the integrity of all electronically processed information based on time will occur. To further complicate the issue, even if an entity's computer software and hardware are year 2000 ready, the entity may be affected by the computer systems of customers, vendors, or third-party data processing services that have made no such modifications. Of particular concern to dealerships would be outside payroll services, banks and other lending and credit institutions, and companies that provide insurance coverage.

.78 Automobile dealerships face unique Year 2000 Issues that may affect the entire entity. The Year 2000 Issue is not necessarily limited to computers but may extend to other equipment with embedded computer chips that are date-sensitive. In addition to the dealership's main computer systems, such as the management system that supports the operations of the dealership, and the communication systems used to share information with manufacturers (such as ordering vehicles or parts, and submitting financial statements), dealerships have many small systems, within the various departments, that should be considered when reviewing for year 2000 compliance. Such systems include—

- Vehicle and parts inventory.
- Finance and insurance.
- Customer tracking (including service and new and used car departments).
- Customer credit checking.
- State emission inspection equipment.
- Parts locator and ordering.
- Vehicle service equipment and service systems.

.79 The NADA has issued a guide, *A Dealer Guide to Resolving the Year 2000 Problem* (Guide BM.19), to help dealerships assess the scope of the year 2000 computer problems. To order this guide, call NADA Management Education at (800) 252-6232, extension 2. Auditors of publicly held companies should consider the guidance set forth by the SEC in its Interpretation "Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences by Public Companies, and Municipal Securities Issues". See *Audit Risk Alert—1998/99* [AAM section 8010] for a summary of this Interpretation or visit the SEC Web site at <http://www.sec.gov>.

.80 It is the responsibility of an entity's management—not the auditor—to assess and remediate the effects of the Year 2000 Issue on an entity's systems. Under generally accepted auditing standards, 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. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Year 2000 Issue or by some other cause.

.81 Auditing guidance relating to the Year 2000 Issue has been developed by the AITF of the ASB. The AITF has issued the following auditing Interpretations:

- Interpretation No. 4, "Audit Considerations for the Year 2000 Issue," of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 9311.38), discusses the auditor's responsibility for the Year 2000 Issue, how it affects planning for an audit of financial statements conducted in accordance with GAAS, and in what circumstances the Year 2000 Issue may result in a reportable condition under SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).
- Interpretation No. 3, "Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization's Description of Controls," of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.19), addresses the responsibilities of service auditors, with respect to information about the Year 2000 Issue in a service organization's description of controls.
- Interpretation No. 2, "Effect of the Year 2000 Issue on the Auditor's Consideration of an Entity's Ability to Continue as a Going Concern," of SAS No. 59 (AICPA, *Professional Standards*, vol. 1, AU sec. 9341.03) provides guidance regarding the identification and evaluation of conditions and events of the type identified in SAS No. 59 that relate to the Year 2000 Issue.

.82 Auditors should be aware of the many auditing and accounting issues that arise from the Year 2000 Issue, including audit planning, going-concern issues, establishing an understanding with the client, impairment, revenue and expense recognition, and disclosure. A more comprehensive discussion of this topic can be found in *Audit Risk Alert—1998/99* [AAM section 8010].

.83 In addition, Internet Web sites that might provide useful year 2000 information to auditors include the following:

- The National Bulletin Board for the Year 2000—<http://www.year2000.com>
- Management Support Technology—<http://www.mstnet.com/year2000>
- National Software Testing Laboratory — <http://www.hstl.com> (free downloadable diagnostic program)

#### **Executive Summary—The Year 2000 (Y2K) Issue**

- Unless corrective actions are taken, the year 2000 may cause accounting and financial information systems to produce inaccurate date-related output.
- The Audit Issues Task Force has issued Interpretations providing guidance to auditors on the Year 2000 Issue.
- Many auditing and accounting issues that arise from the Year 2000 Issue including audit planning, going-concern issues, establishing an understanding with the client, impairment, revenue and expense recognition, and disclosure. A more comprehensive discussion of this topic can be found in *Audit Risk Alert—1998/99* [AAM section 8010].

## New Auditing Pronouncements

*What new auditing pronouncements have been issued over the past two years?*

### New Auditing Standards

#### **SAS No. 87, Restricting the Use of an Auditor's Report**

.84 SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532), was issued in September 1998 by the ASB and is effective for reports issued after December 31, 1998. SAS No. 87 provides guidance to auditors in determining whether an engagement requires a restricted-use report and, if so, what elements to include in that report. SAS No. 87 states that an auditor should restrict the use of a report when—

- The subject matter of the auditor's report, or the presentation being reported on, is based on measurement or disclosure criteria contained in contractual agreements or regulatory provisions that are not in conformity with GAAP or OCBOA.
- The accountant's report is based on procedures that are specifically designed and performed to satisfy the needs of specified parties who accept responsibility for the sufficiency of the procedures.
- The auditor's report is issued as a by-product of a financial statement audit and is based on the results of procedures designed to enable the auditor to express an opinion on the financial statements taken as a whole, not to provide assurance on the specific subject matter of the report.

In addition to describing the circumstances in which the use of an auditor's report should be restricted, SAS No. 87, among other things, defines the terms *general use* and *restricted use*, specifies the language to be used in restricted-use reports, and requires an auditor to restrict a single combined report if it covers subject matter or presentations that ordinarily do not require a restriction on use and subject matter or presentations that require such a restriction. It permits auditors to include a separate general-use report in a document that also contains a restricted-use report.

#### **SAS No. 86, Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties**

.85 SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties*, issued in March 1998 by the ASB, amends SAS No. 72 to reflect the issuance of Statement on Standards for Attestation Engagements (SSAE) No. 8, *Management's Discussion and Analysis* (AICPA, *Professional Standards*, vol. 1, AT sec. 700). SAS No. 86 allows practitioners who have examined or reviewed management's discussion and analysis (MD&A) in accordance with the provisions of SSAE No. 8 to state that fact in the introductory section of the comfort letter (a special type of agreed-upon procedures report that may be issued in connection with a securities offering) and attach a copy of the SSAE No. 8 report to the comfort letter. SAS No. 86 presents examples of comfort letters that contain references to either an examination of annual MD&A or a review of interim MD&A. SAS No. 86 is effective for comfort letters issued on or after June 30, 1998.

#### **SAS No. 21, Segment Information—Rescinded**

.86 SAS No. 21, *Segment Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 435), contained guidance for auditing disclosures made in accordance with the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 was superseded upon the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB, *Current Text*, vol. 1, sec. S30), which is effective for fiscal years beginning after December 15, 1997. Accordingly, the ASB has rescinded SAS No. 21 effective for audits of financial state-

ments to which FASB Statement No. 131 has been applied. In its place, Auditing Interpretation No. 4, "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter*, has been issued.

### **SAS No. 85, Management Representations**

.87 The ASB issued SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), in November 1997. SAS No. 85 provides guidance regarding written management representations to be obtained by an auditor as part of an audit performed in accordance with generally accepted auditing standards. SAS No. 85—

- Clarifies the requirement for an auditor to obtain written representations for all financial statements and periods covered by the auditor's report.
- Includes a representation made by management that states that it is management's belief that the financial statements are fairly presented in conformity with GAAP.
- Includes a list of updated specific representations to be obtained from management that are consistent with representations obtained in current practice. Such representations include information concerning fraud as referred to in SAS No. 82 and significant estimates and material concentrations known to management that are required to be disclosed in accordance with SOP 94-6.
- States that the auditor ordinarily should obtain a representation letter tailored to cover representations relating to the financial statements unique to the entity's business or industry and includes a listing of additional representations that may be appropriate in certain situations.

SAS No. 85 is effective for audits of financial statements for periods ending on or after June 30, 1998.

### **SAS No. 84, Communications Between Predecessor and Successor Auditors**

.88 In October 1997, the ASB issued SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). This Statement provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place. SAS No. 84—

- Expands the required communications with the predecessor auditor before the successor auditor accepts an engagement to include inquiries about communications made by the predecessor auditor to audit committees or others with equivalent authority and responsibility as described in SAS No. 82; SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317); SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325); and any other reasonable inquiries that the successor auditor may wish to ask the predecessor auditor.
- Clarifies the successor auditor's responsibility with respect to obtaining sufficient competent evidential matter used in analyzing the impact of the opening balances on the current year financial statements and consistency of accounting principles as a matter of professional judgment.
- Expands the working papers ordinarily made available to the successor auditor by the predecessor auditor to include documentation of planning, internal control, audit results, and other matters of continuing audit significance.
- Provides communication guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor.
- Introduces an illustrative client consent and acknowledgement letter and an illustrative successor auditor acknowledgment letter. A predecessor auditor may conclude that obtaining written communications from both the former client and the successor auditor will allow greater communication between both parties and greater access to the working papers than would be the case in the absence of such communications.

SAS No. 84 is effective with respect to acceptance of an engagement after March 31, 1998.

### **SAS No. 83, Establishing an Understanding With the Client**

.89 In October 1997, the ASB issued SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310). SAS No. 83—

- Requires the auditor to establish an understanding with the client that includes the objectives of the engagement, the responsibilities of management and the auditor, and any limitations of the engagement.
- Requires the auditor to document the understanding with the client in the working papers, preferably through a written communication with the client.
- Provides guidance for situations in which the practitioner believes that an understanding with the client has not been established.

SAS No. 83 also identifies specific matters that ordinarily would be addressed in the understanding with the client, and other contractual matters an auditor might wish to include in the understanding. SAS No. 83 is effective for engagements for periods ending on or after June 15, 1998.

### **SAS No. 82, Consideration of Fraud in a Financial Statement Audit**

.90 In February 1997, the ASB issued SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, 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 supersedes SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and is effective for audits of financial statements for periods ending on or after December 15, 1997.<sup>9</sup>

#### **Executive Summary—New Auditing Standards**

- SAS No. 87, *Restricting the Use of an Auditor's Report*
- SAS No. 86, *Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties*
- SAS No. 85, *Management Representations*
- SAS No. 84, *Communications Between Predecessor and Successor Auditors*
- SAS No. 83, *Establishing an Understanding With the Client*
- SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*
- Rescission of SAS No. 21, *Segment Information*

### **New Auditing Interpretations**

.91 Auditing Interpretations are issued by the AITF of the ASB to provide timely guidance on the application of ASB pronouncements. Interpretations are reviewed by the ASB, but are not as authoritative as ASB pronouncements. Nevertheless, a departure from an Interpretation may have to be justified if the quality of a member's work is questioned. Interpretations are effective upon publication in the *Journal of Accountancy*. A listing of recently issued Interpretations is presented below. For a complete description of the new auditing Interpretations, see *Audit Risk Alert—1998/99* [AAM section 8010].

#### **New Auditing Interpretations**

- Interpretation No. 4 "Applying Auditing Procedures to Segment Disclosures in Financial Statements," of SAS No. 31, *Evidential Matter*

<sup>9</sup> SAS No. 82 also amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS No. 1 (AICPA, *Professional Standards*, vol. 1 AU sec. 110, "Responsibilities and Functions of the Independent Auditor", and AU sec. 230, "Due Professional Care in the Performance of Work").



- Interpretation No. 3, “Commenting in a Comfort Letter on Quantitative and Qualitative Disclosures About Market Risk Made in Accordance With Item 305 of Regulation S-K,” of SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties*
- Interpretation No. 4, “Audit Considerations for the Year 2000 Issue”, of AU section 311, “Planning and Supervision”
- Interpretation of SAS No. 73, *Using the Work of a Specialist*, “The Use of Legal Interpretations as Evidential Matter to Support Management’s Assertion that a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Statement of Financial Accounting Standards No. 125”
- Interpretation No. 3, “Responsibilities of Service Organizations and Service Auditors With Respect to Information About the Year 2000 Issue in a Service Organization’s Description of Controls”, of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*
- Interpretation No. 2, “Effect of the Year 2000 Issue on the Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern”, of SAS No. 59, *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*

## New AITF Advisories

.92 A listing of recently issued AITF Advisories is presented below. For a complete description of the new auditing advisories, see *Audit Risk Alert—1998/99* [AAM section 8010].

- AITF Advisory, *Reporting Comprehensive Income*
- AITF Advisory, *Practice Issues Regarding Language to Permit the Use of Legal Opinions by Auditors*

New ASB Statements of Position (SOP) are presented in the “New AICPA Statements of Position” section of this Audit Risk Alert.

## Recent GAAP Pronouncements

*What new accounting pronouncements have been issued over the past two years?*

### New FASB Pronouncements

#### **FASB Statement No. 134, Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise**

.93 The FASB issued Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*, in October 1998 to amend FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*. FASB Statement No. 134 is effective for the first fiscal quarter beginning after December 15, 1998. Early application is encouraged.

#### **FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities**

.94 In June 1998, the FASB issued Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities* (FASB, *Current Text*, vol. 1, sec. D50). FASB Statement No. 133 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as *derivatives*), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (1) a hedge of the

exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (2) a hedge of the exposure to variable cash flows of a forecasted transaction; or (3) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction.

.95 The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation.

.96 For a derivative designated as hedging the exposure to changes in the fair value of a recognized asset or liability or a firm commitment (referred to as a *fair-value hedge*), the gain or loss is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged. The effect of that accounting is to reflect in earnings the extent to which the hedge is not effective in achieving offsetting changes in fair value.

.97 For a derivative designated as hedging the exposure to variable cash flows of a forecasted transaction (referred to as a *cash-flow hedge*), the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. The ineffective portion of the gain or loss is reported in earnings immediately.

.98 For a derivative designated as hedging the foreign currency exposure of a net investment in a foreign operation, the gain or loss is reported in other comprehensive income (outside earnings) as part of the cumulative translation adjustment. The accounting for a fair-value hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of an unrecognized firm commitment or an available-for-sale security. Similarly, the accounting for a cash-flow hedge described above applies to a derivative designated as a hedge of the foreign currency exposure of a foreign-currency-denominated forecasted transaction.

.99 For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

.100 Under FASB Statement No. 133, an entity that elects to apply hedge accounting is required to establish at the inception of the hedge (1) the method it will use for assessing the effectiveness of the hedging derivative and (2) the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk. FASB Statement No. 133 applies to all entities.

.101 FASB Statement No. 133 precludes designating a nonderivative financial instrument as a hedge of an asset, liability, unrecognized firm commitment, or forecasted transaction except that a nonderivative instrument denominated in a foreign currency may be designated as a hedge of the foreign currency exposure of an unrecognized firm commitment denominated in a foreign currency or a net investment in a foreign operation.

.102 FASB Statement No. 133 amends FASB Statement No. 52, *Foreign Currency Translation* (FASB, *Current Text*, vol. 1, sec. P16), to permit special accounting for a hedge of a foreign currency forecasted transaction with a derivative. It supersedes FASB Statements No. 80, *Accounting for Futures Contracts* (FASB, *Current Text*, vol. 1, sec. F80), No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25), and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25). It amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FASB, *Current Text*, vol. 1, sec. F25), to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105. FASB Statement No. 133 also nullifies or modifies the consensus reached in a number of issues addressed by the EITF.

.103 FASB Statement No. 133 is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Initial application of FASB Statement No. 133 should be as of the beginning of an entity's fiscal quarter; on that date, hedging relationships must be designated anew and documented pursuant to the provisions of the Statement. Earlier application of all of the provisions of FASB Statement No. 133 is encouraged, but it is permitted only as of the beginning of any fiscal quarter that begins after issuance of the Statement. FASB Statement No. 133 should not be applied retroactively to financial statements of prior periods.

***FASB Statement No. 132, Employers' Disclosures about Pensions and Other Postretirement Benefits (an amendment of FASB Statements No. 87, 88, and 106)***

.104 In February 1998, the FASB issued Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of FASB Statements No. 87, 88, and 106 (FASB, *Current Text*, vol. 1, secs. P16 and P40). FASB Statement No. 132 revises employers' disclosures about pension and other postretirement benefit plans. It does not change the measurement or recognition of those plans. It standardizes the disclosure requirements for pensions and other postretirement benefits to the extent practicable, requires additional information on changes in the benefit obligations and fair values of plan assets that will facilitate financial analysis, and eliminates certain disclosures that are no longer as useful as they were when FASB Statements No. 87, *Employers' Accounting for Pensions* (FASB, *Current Text*, vol. 1, sec. P16), No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FASB, *Current Text*, vol. 1, sec. P16), and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40), were issued. FASB Statement No. 132 suggests combined formats for presentation of pension and other postretirement benefit disclosures. It also permits reduced disclosures for nonpublic entities.

.105 FASB Statement No. 132 is effective for fiscal years beginning after December 15, 1997. Earlier application is encouraged. Restatement of disclosures for earlier periods provided for comparative purposes is required unless the information is not readily available, in which case the notes to the financial statements should include all available information and a description of the information not available.

***FASB Statement No. 130, Reporting Comprehensive Income***

.106 FASB Statement No. 130, *Reporting Comprehensive Income* (FASB, *Current Text*, vol. 1, sec. C49), establishes standards for reporting and display of comprehensive income and its components (revenue, expenses, gains, and losses) in a full set of general-purpose financial statements. If a dealership does not have any items of other comprehensive income (such as unrealized gains and losses on available-for-sale marketable securities, minimum pension liability adjustments, or foreign currency translation adjustments) in a period presented, the dealership would not be required to report comprehensive income. However, if the dealership does have any items of other comprehensive income, FASB Statement No. 130 requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. FASB Statement No. 130 does not require a specific format for that financial statement, but does require that an enterprise display an amount representing total comprehensive income for the period in that financial statement. FASB Statement No. 130 also requires that an enterprise (1) classify items of other comprehensive income by their nature in a financial statement and (2) display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in-capital in the equity section of a statement of financial position.

.107 FASB Statement No. 130 is effective for fiscal years beginning after December 15, 1997. Reclassification of financial statements for earlier periods provided for comparative purposes is required.

.108 In 1998 the AITF issued the *Advisory Reporting Comprehensive Income* to provide auditors with guidance on how the adoption of FASB Statement No. 130 will affect the auditor's report.

**Executive Summary—New FASB Pronouncements**

- FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise*
- FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, an amendment of FASB Statements No. 87, 88, and 106
- FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*
- FASB Statement No. 130, *Reporting Comprehensive Income*
- FASB Statement No. 129, *Disclosures of Information about Capital Structure*
- FASB Statement No. 128, *Earnings Per Share*
- FASB Statement No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*

For a description of all the FASB Statements listed here, visit the FASB Web site at <http://www.fasb.org>

**New AICPA Statements of Position**

.109 For a complete summary of all AICPA SOPs issued this year, see *Audit Risk Alert—1998/99* [AAM section 8010].

**SOP 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use**

.110 In March 1998, the Accounting Standards Executive Committee (AcSEC) issued SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. This SOP requires the following:

- Computer software costs that are incurred in the preliminary project stage should be expensed as incurred. Once the capitalization criteria of the SOP have been met, external direct costs of materials and services consumed in developing or obtaining internal-use computer software; payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal-use computer software project (to the extent of the time spent directly on the project); and interest costs incurred when developing computer software for internal use should be capitalized. Training costs and many kinds of data conversion costs should be expensed as incurred.
- Internal costs incurred for upgrades and enhancements that add functionality should be expensed or capitalized using the same criteria as for new software. Internal costs incurred for maintenance should be expensed as incurred. Entities that cannot separate internal costs on a reasonably cost-effective basis between maintenance and relatively minor upgrades and enhancements should expense such costs as incurred.
- External costs incurred under agreements related to specified upgrades and enhancements should be expensed or capitalized using the same criteria as for new software. However, external costs related to maintenance, unspecified upgrades and enhancements, and costs under agreements that combine the costs of maintenance and unspecified upgrades and enhancements should be recognized in expense over the contract period on a straight-line basis unless another systematic and rational basis is more representative of the services received.
- Impairment should be recognized and measured in accordance with the provisions of FASB Statement No. 121, *Accounting for the Assets to Be Disposed Of* (FASB, *Current Text*, vol. 1, sec. 108).
- The capitalized costs of computer software developed or obtained for internal use should be amortized on a straight-line basis unless another systematic and rational basis is more representative of the software's use.

- If, after the development of internal-use software is completed, an entity decides to market the software, proceeds received from the license of the computer software, net of direct incremental costs of marketing, should be applied against the carrying amount of that software.

SOP 98-1 identifies the characteristics of internal-use software and provides examples to assist in determining when computer software is for internal use. The SOP applies to all nongovernmental entities and is effective for financial statements for fiscal years beginning after December 15, 1998. It should be applied to internal-use software costs incurred in those fiscal years for all projects, including those projects in progress upon initial application of the SOP. Earlier application is encouraged in fiscal years for which annual financial statements have not been issued. Costs incurred prior to initial application of SOP 98-1, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized had this SOP been in effect when those costs were incurred.

#### **Executive Summary—New AICPA Statements of Position**

- SOP 97-2, *Software Revenue Recognition*
- SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*
- SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*
- SOP 98-4, *Deferral of the Effective Date of a Provision of SOP 97-2, Software Revenue Recognition*
- SOP 98-5, *Reporting on the Costs of Start-Up Activities*
- SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*
- SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*
- SOP 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934; Rule 17Ad-18 of the Securities Exchange Act of 1934; and Advisories No. 17-98 and No. 42-98 of the Commodity Futures Trading Commission.*

## **AICPA Services**

- .111 For a complete listing of AICPA Services see *Audit Risk Alert*—1998/99 [AAM section 8010].

## **Continuing Professional Education**

- .112 The AICPA offers the following self-study course—

- Automobile Dealership Accounting (Product no. 735147)

- .113 The AICPA offers the following group study course—

- *Auto Dealerships: Audit, Accounting and Tax Issues* (visit the AICPA Web site at <http://www.aicpa.org/store/csearch.htm> for a current schedule of where this course is offered, or call your state society for complete details. Registration for all group study courses is done through your state CPA society.)

## **National Auto Dealership Conference**

- .114 Each fall the AICPA sponsors a National Auto Dealership Conference that is specifically designed to update auditors and dealers on significant accounting, auditing, legal, financial, and tax developments affecting the auto dealership industry. Information on the conference may be obtained by calling the AICPA Conferences Division at (201) 938-3556.

## Order Information

.115 Copies of AICPA publications referred to in this document may be obtained by calling the AICPA Order Department at (888) 777-7077 or faxing a request to (800) 362-5066. Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

.116 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— 1998/99* [AAM section 8010].

.117 The Audit Risk Alert *Auto Dealership Industry Developments* will be published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be greatly appreciated. You may email them to [ldelahanty@aicpa.org](mailto:ldelahanty@aicpa.org) or write to:

Linda C. Delahanty, CPA  
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201 Plaza Three  
Jersey City, NJ 07311-3881

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## Sources of Information

Organization	General Information	Fax Services	Electronic Bulletin Board Services	Recorded Announcements
American Institute of Certified Public Accountants	<i>Order Department</i> Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	Internet address— <a href="http://www.aicpa.org">http://www.aicpa.org</a>	
Financial Accounting Standards Board	<i>Order Department</i> P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		Internet address— <a href="http://www.fasb.org">http://www.fasb.org</a>	
National Automobile Dealers Association <sup>10</sup>	8400 Westpark Drive McLean, VA 22102		Internet address— <a href="http://www.nada.org">http://www.nada.org</a>	(703) 821-7000
American International Auto Dealers Association <sup>11</sup>	99 Canal Center Plaza Alexandria, VA 22314-1538			

State and regional not-for-profit organizations promoting the interests of automobile dealerships can be found in most states. These organizations generally stay abreast of state and local legislative issues and communicate these issues to their membership through newsletters.

[The next page is 9001.]

<sup>10</sup> The National Automobile Dealers Association is a not-for-profit organization promoting the interests of franchised new car and truck dealers in the United States. The NADA publishes economic newsletters, a monthly magazine, used car valuation guides, and other information on various aspects of dealerships.

<sup>11</sup> The American International Auto Dealers Association is an organization promoting the interests of foreign franchises.





# AAM Section 9000

## Supervision, Review and Report Processing

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

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

The material in this section has been extracted from the MAP Handbook and has been edited for this manual.

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# AAM Section 9100

## *Supervision and Review Procedures*

### Introduction

.01 Supervision is an important phase of all engagements. A supervisor trains staff members, determines that there is an understanding of the work to be performed and ascertains that all procedures were appropriately performed.

.02 Review procedures are necessary to determine whether the objectives of the engagement and the results of the procedures performed were consistent with the conclusions presented in the accountant's or auditor's report.

### Authoritative Literature

.03 The necessity for supervision is emphasized in the *AICPA Code of Professional Conduct*, which applies to all major areas of accounting practice, Rule 201, *General Standards* (ET section 201.01) states, "A member shall adequately plan and *supervise* an engagement."

.04 The first standard of fieldwork of generally accepted auditing standards states: "The work is to be adequately planned and assistants, if any, are to be properly *supervised*."

.05 For compilation and review engagements, SSARS 1, *Compilation and Review of Financial Statements*, paragraph 3 (AR section 100.03), provides the guidance necessary to enable the accountant to comply with the general standards of the profession as explained in .03 above.

.06 For audit engagements, the following Statements on Auditing Standards (SAS) provide specific guidance on supervising and reviewing audit engagements:

- a. SAS No. 22, *Planning and Supervision* and SAS No. 77, *Amendments to Statements on Auditing Standards No. 22, Planning and Supervision*, No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and No. 62, *Special Reports* (AU section 311), establishes broad requirements for the review of the work of assistants.
- b. SAS No. 39, *Audit Sampling* (AU section 350), states that nonsampling risk can be reduced to a negligible level through such factors as adequate planning and supervision and proper conduct of a firm's audit practice.
- c. SAS No. 41, *Working Papers* (AU section 339), establishes requirements for documenting the supervision of work performed.
- d. SAS No. 56, *Analytical Procedures* (AU section 329), provides guidance on the use of analytical procedures and requires their use in both the planning and review of audits.
- e. SAS No. 75, *Engagements to Apply Agreed-Upon Procedures to Specified Accounts, or Items of a Financial Statement* (AU Section 622), states that accountant's risks can be reduced through adequate planning and supervision and due professional care in performing the procedures, determining the findings, and preparing the report.

.07 In addition, the AICPA's Statement on Quality Control Standards 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. One of the elements of a quality control system discussed in this standard is supervision. Supervision as an element of quality control is defined as policies and procedures for the conduct and supervision of work to provide that the firm's work meets its standard of quality.

## Phases of Supervision and Review

.08 Supervision and review are conducted in several phases:

- a. Instructing and training assistants.
- b. Providing the staff with an efficient and effective approach to the performance of the engagement.
- c. Keeping informed of significant problems encountered.
- d. Reviewing the work performed.
- e. Comparing the time spent on performing the procedures required with the budget prepared for those procedures.
- f. Dealing with technical differences of opinion among firm personnel.

## Review Organization

.09 A firm's practice for reviewing engagements will vary depending on the size of the firm and on the complexity of the engagement.

.10 Some firms can justify a separate review department, while others cannot afford this functional division of duties. Firms cannot afford to omit any of the review procedures or processes. There should always be some form of reading of the reports for both professional and accounting matters as well as typographical errors after they are typed.

## Firm Policy and Procedures Regarding Supervision and Review

.11 The foundation of good supervision is adequate firm policies and procedures on conducting and supervising work performed. Some examples of such policies are:

- a. Procedures for planning engagements (AAM section 3000).
- b. Procedures for maintaining the quality of work performed (AAM section 11,000).
- c. Procedures for reviewing engagement workpapers and reports.

.12 The procedures for reviewing engagement workpapers and reports is broken into two separate components. The two components consist of (1) detailed review of the workpapers by the audit senior and (2) the higher-level supervisory review performed by the manager and partner on the engagement.

## Review of Workpapers

.13 The purpose of the detailed review of the workpapers on an engagement is to determine that:

- a. All procedures in the program, albeit audit, review or compilation, were performed and documented.
- b. The results and conclusions reached are appropriate for the work performed.
- c. The results are properly summarized and in agreement with the report to be issued.

## Supervisory Review

- .14 The purpose of the supervisory review is to determine that:
- a. Professional and firm standards have been complied with.
  - b. Accounting and auditing concerns for the client's industry were evaluated properly.
  - c. The overall results of the procedures performed are appropriate.

## Purpose of Form

.15 The In-Charge's and Partner's Engagement Review Programs are tools used for determining whether all engagement steps were properly considered, completed, and resolved. The In-Charge should complete the respective form by checking off "yes," "no," or "n/a" in the appropriate column. All "no" answers should be explained with a separate memorandum. The Partner should sign off on the In-Charge's Engagement Review Program and then complete the Partner's Engagement Review Program in the same manner.

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*[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.*

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>I. General Procedures</b>			
<b>A. .010 General</b>			
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 fraud and management's ability to override controls. (SAS Nos. 47 and 82 [AU sections 312 and 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			

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<i>b.</i> Was the sample selected in such a way that it could be expected to be representative of the population?	_____	_____	_____
<i>c.</i> Were the results of the sample evaluated as to their effect on the nature, timing, and extent of planned substantive procedures?	_____	_____	_____
<i>d.</i> 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?	_____	_____	_____
<i>e.</i> 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]):			
<i>a.</i> 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?	_____	_____	_____
<i>b.</i> Was the sample selected in such a way that it could be expected to be representative of the population?	_____	_____	_____
<i>c.</i> Were the misstatement results of the sample projected to the items from which the sample was selected?	_____	_____	_____
<i>d.</i> Was appropriate consideration given, in evaluating the sample, to items for which the planned substantive tests or appropriate alternate procedures could not be performed?	_____	_____	_____
<i>e.</i> 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?	_____	_____	_____
<i>f.</i> 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:			
<i>a.</i> Audit planning?	_____	_____	_____
<i>b.</i> Use as a substantive test?	_____	_____	_____
<i>c.</i> 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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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. 85 [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, fraud, or illegal acts, if any, followed up in accordance with SAS Nos. 82 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 fraud and management's ability to override control procedures? (SAS No. 82 [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 act of fraud 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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
b. Obtain satisfaction that, in view of the organizational position of the likely perpetrator, the fraud 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 act of fraud 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 fraud 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 fraud exist and, if so, its 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?

\_\_\_\_\_

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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>B. .030 Receivables</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
<b>D. .050 Investments</b>			
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?	_____	_____	_____
<b>E. .060 Prepaid Expenses, Intangible Assets, Deferred Charges, Etc.</b>			
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)?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
<b>F. .070 Property, Plant, and Equipment</b>			
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?	_____	_____	_____
<b>G. .080 Current Liabilities</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>H. .090 Long-Term Debt</b>			
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?	_____	_____	_____
<b>I. .100 Deferred Credits</b>			
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?	_____	_____	_____
<b>J. .110 Income Taxes</b>			
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?	_____	_____	_____
<b>K. .120 Commitments and Contingencies</b>			
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.	_____	_____	_____



	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
<b>L. .130 Capital Accounts</b>			
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?	_____	_____	_____
<b>M. .140 Income and Expenses</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>N. .150 Other</b>			
1. Were procedures applied to supplementary information in accordance with SAS No. 52 (AU section 558), as applicable?	_____	_____	_____
2. If the work of a specialist was used, was the effect of the specialist's work on the auditor's report considered in accordance with SAS No. 73 (AU section 336)?	_____	_____	_____
3. Were specific procedures applied for determining the existence of related parties and examining identified related party transactions? (SAS No 45 [AU section 334])	_____	_____	_____
4. Was the guidance in SAS No. 47 (AU section 312) regarding audit risk and materiality considered during the planning and performance of the engagement?	_____	_____	_____

This audit engagement has been completed in accordance with professional standards and firm policy.

In-Charge \_\_\_\_\_ Date \_\_\_\_\_

Partner \_\_\_\_\_ Date \_\_\_\_\_

\_\_\_\_\_

[The next page is 9241.]

# AAM Section 9210

## *Partner's Engagement Review Program*

.01

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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, fraud, illegal acts, and reportable conditions adequately followed up and communicated including reporting, communication, other audit effects, legal consultation, etc.?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
n. Does the firm's disclosure checklist document that the audit report is properly prepared and that the financial statements are fairly stated?	_____	_____	_____
o. Were matters related to the conduct of the audit communicated to those who have responsibility for oversight of the financial reporting process?	_____	_____	_____
p. Did the partner sign the In-Charge Engagement Review Program?	_____	_____	_____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner \_\_\_\_\_ Date \_\_\_\_\_

\_\_\_\_\_

[The next page is 9271.]

# AAM Section 9220

## *Partner's Engagement Review Program Supplement for Not-for-Profit Organizations*

*To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]*

Yes      No      N/A

### **I. General Audit Procedures**

#### **A. .010 General**

[No additional General Audit Procedures are required as part of this supplement.]

### **II. Working Paper Areas**

#### **A. .020 Cash**

##### **1. Do the working papers indicate that the following were considered?**

*a. Confirmation of liabilities and contingent liabilities to banks.*

\_\_\_\_\_

*b. Authorization for interfund cash transactions.*

\_\_\_\_\_

*c. Determination that all cash accounts have been identified and appropriately recorded.*

\_\_\_\_\_

#### **B. .030 Receivables**

##### **1. Were procedures performed to provide evidence that pledged receivables are properly recorded in the appropriate funds?**

\_\_\_\_\_

#### **C. .040 Investments**

##### **1. Were income and realized and unrealized gains and losses from investments examined for proper allocation to the individual funds?**

\_\_\_\_\_

##### **2. Do the working papers indicate that risk of loss on repurchase agreements was properly considered?**

\_\_\_\_\_

##### **3. Do the working papers indicate that repurchase security transactions were reviewed for consistency with the disclosures of the terms or circumstances of the transactions?**

\_\_\_\_\_

#### **D. .050 Collections of Works of Art and Similar Items**

##### **1. If the collection is considered inexhaustible (i.e., exhibits owned by museums, art galleries, botanical gardens, etc.) and has been capitalized, do the working papers indicate that the auditor tested the reasonableness of the collection's carrying value?**

\_\_\_\_\_

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
<b>E. .060 Property, Plant, and Equipment</b>			
1. Was a review made to determine that capital expenditures are classified in the proper fund accounts?	_____	_____	_____
<b>F. .070 Liabilities</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>G. .080 Deferred Revenue</b>			
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?	_____	_____	_____
<b>H. .090 Commitments and Contingencies</b>			
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?	_____	_____	_____
<b>I. .100 Fund Balance</b>			
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?	_____	_____	_____
<b>J. .110 Revenues, Expenses, Support, and Capital Additions</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
<b>K. .120 Other</b>			
1. If the entity is affiliated or otherwise financially related to other entities, did the auditor consider the need for combined financial statements or disclosure of the relationship?	_____	_____	_____



Yes      No      N/A

### III. Audits of Governmental Grantees

**Note:** These questions are derived from the U.S. General Accounting Office's (GAO) *Government Auditing Standards* ("Yellow Book") and the Office of Management and Budget, Circular A-110 (*Uniform Administrative Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations*).

#### A. .130 General

1. If the audit was required to be conducted in accordance with the *Government Auditing Standards*, do the auditor's report(s) include references to *Government Auditing Standards*, and appropriately cover:
  - a. The financial statements, including, where presented, the combining and individual fund financial statements? \_\_\_\_\_
  - b. Tests of controls based solely on the evaluation of the effectiveness of the controls made as part of the audit of the financial statements? \_\_\_\_\_
  - c. Compliance with finance-related legal and contractual provisions, including a summary of questioned costs and/or instances of noncompliance? \_\_\_\_\_
  - d. Instances or indications of illegal acts that could result in criminal prosecution of the top officials of the entity arranging the audit? \_\_\_\_\_
2. If required, did the auditor's report on internal control identify:
  - a. The scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk? \_\_\_\_\_
  - b. The entity's significant internal control structure including those controls established to ensure compliance with laws and regulations that have a material impact on the financial statements? \_\_\_\_\_
  - c. The reportable conditions, including the identification of material weaknesses identified as a result of the auditor's work in understanding and assessing control risk? \_\_\_\_\_
3. If required, did the auditor's report on compliance include:
  - a. A statement of positive assurance with respect to those items tested for compliance with applicable laws and regulations? \_\_\_\_\_
  - b. Negative assurance on those items not tested? \_\_\_\_\_
  - c. A summary of material instances of noncompliance? \_\_\_\_\_
4. If required by contractual obligations, were findings presented in accordance with the guidance in the *Government Auditing Standards* regarding reporting on economy and efficiency audits and program results audits? \_\_\_\_\_
5. Was interfund activity properly reviewed and were differences between total interfund receivables and total interfund payables investigated and resolved? \_\_\_\_\_

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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 <i>Government Auditing Standards</i> , paragraphs 5-26 through 5-28; OMB A-110, Attachment F)	_____	_____	_____
8. Do the working papers indicate that consideration was given to prior audits of government financial assistance programs that disclosed questionable or disallowed costs, or instance of noncompliance?	_____	_____	_____

This audit engagement has been completed in accordance with professional standards and firm policy.

Partner \_\_\_\_\_ Date \_\_\_\_\_

\_\_\_\_\_  
[The next page is 9301.]

# AAM Section 9230

## *Partner's Engagement Review Program Supplement for Banks*

*To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]*

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>I. General Procedures</b>			
<b>A. .010 General</b>			
1. Were FIRREA regulations considered in planning the audit engagement?	_____	_____	_____
<b>II. Working Paper Areas</b>			
<b>A. .020 General</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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>B. .030 Cash</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
<b>C. .040 Investment and Trading Securities</b>			
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?	_____	_____	_____
<b>D. .050 Federal Funds and Repurchase/Reverse Repurchase Agreements</b>			
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?	_____	_____	_____
<b>E. .060 Loans</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
<b>F. .070 Deposits</b>			
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?	_____	_____	_____
<b>G. .080 Director's Examinations</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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)?	_____	_____	_____
<b>H. .090 Trust Operations</b>			
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?	_____	_____	_____

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[The next page is 9401.]



# AAM Section 9500

## *Report Processing*

### Drafting the Report

.01 This section provides guidance for preparing and processing the financial statements and notes and the appropriate auditor's report.

.02 Auditors should establish policies and procedures that would define responsibility regarding the preparation and review of the financial statements and the notes thereto and preparation of the auditor's report. (See AAM section 10,100 for a detailed discussion of the auditor's report.)

### Uniformity

.03 Strict uniformity may stifle creative thinking, but a consistent format adds quality to the financial statement notes and auditor's report (the "report").

- a. The client's name should appear at the top of every statement with identical spelling and punctuation. The certificate of incorporation should be inspected to determine the exact name of the corporation. Accuracy in seemingly small matters, such as whether "the" is part of the name, the word "Company" or "Incorporated" is abbreviated or spelled out, or commas are part of the name, is important to the accountant's reputation.
- b. Descriptive phraseology should be uniform. If the phrase "cost of goods sold" is used in the income statement, then a schedule of these costs should show "cost of goods sold," not "cost of sales."
- c. The manner in which the date or period covered is indicated should also be uniform. If the income statement is headed "for the year ended December 31, 19\_\_\_\_," then all supporting schedules should be headed that way, rather than "for the year 19\_\_\_\_."
- d. Schedule and statement headings should conform to a pattern. For example, if "schedule of cost of goods sold" is used, then all other schedules should begin with "schedule of."
- e. Statement and schedule headings should be the same in the letter, table of contents, index, and other references.
- f. Each page should be well balanced, paragraphs should break in the right places, tables should be centered and not broken except when a table is longer than a page, page numbers should be in the same place on each sheet, type should be clean and alignment even, and there should be no "strikeovers" or visible erasures.
- g. As part of firm policy, the following should be standardized:

Title	Captions
Indexing	Spacing
Salutation	Indentation
Page Numbering	Paragraphing
Closing and Signing	Capitalization
Dating	Underscoring
Whole Dollar Reporting	Punctuation
Headings	Dollar Signs
Double or Single Spacing	

## Draft of Report

.04 In some cases a draft of the report, clearly identified as a draft, can be used effectively to afford the client an opportunity to comment on the report before it is in final form.

## Report Production

.05 A *report guide sheet* usually accompanies all reports submitted for processing. Included in the report guide sheet is the basic information which relates to the specific client, such as:

- a. Client name
- b. Audit date
- c. Engagement partner and manager
- d. Date audit commenced
- e. Date audit completed
- f. Date report submitted for review
- g. Date review completed
- h. Date submitted for typing
- i. Date submitted for checking
- j. Date sent to client
- k. Special comments, such as "rush," "date promised to client," and "hold for confirmation."

.06 The purpose of the report guide sheet is to enable the audit team to know the status of the report at all times, and to ascertain if there are any time lags in the processing of the report. The following procedures are used in its preparation.

*Engagement information.* The in-charge accountant enters the engagement information, delivery instructions, and "hold items" (items to be cleared prior to releasing report). He signs the report guide sheet as initial reviewer.

*Review.* The report is approved at various levels or review. If there is more than one reviewer (for example, two department reviewers for phases of a large job), the primary reviewer should sign the report guide sheet. If another partner or manager performed the entire review in the absence of the primary reviewer, then such other reviewer should sign the report guide sheet as overall reviewer.

*Processing.* The various processing levels are signed off. If more than one typist is involved, the head of the typing department or the primary typist may sign the report guide sheet. If more than one person is involved in comparing and proofing, the person primarily responsible should sign the report guide sheet. The review partner or his delegate should sign as final reader.

*Final release.* The person who signs for final release must ascertain that all other required signatures are on the report guide sheet before releasing the report.

*Report production.* The reverse side of the report guide sheet is usually completed by the in-charge accountant. A photocopy may be given to the report production department as advance notice of production requirements (for example, where numerous printed covers will be needed).

.07 The report guide sheet is bound with the operating office's file copy of the report. With the busy atmosphere prevailing at most firms, it is of vital importance that all work as it moves through the production process be under tight control independent of the work product and its guide sheet.

.08 A simple schedule can be maintained to control the flow of work from the date an audit engagement is begun to the date the report is finally mailed to the client. The schedule has key items arranged in columnar form and can be maintained by the office manager or another person in charge of staff assignments. Frequent references to the schedule should reveal any unusual delays in completing an engagement or typing a report.

.09 To account for each report from the time it is placed for typing to the time it is mailed or delivered to the client, some firms maintain a record in the typing department, in place of or as a supplement to the foregoing record. (See Report Production Control in AAM section 9500.13.)

.10 If this record indicates any time lags, the matter should be investigated; it may indicate either an abnormal backlog of work or some other problem.

.11 In preparing the report production control form, the following procedures are suggested:

- It should be manually prepared and updated daily by a control clerk.
- It should be retained in a notebook in a readily accessible location so that audit personnel can check report status without interfering with review and production operations.
- When a report and related workpapers are received by the reviewer, the client name, report description, fiscal year end, report-letter date, and due date should be entered.
- The review partner should assign a reviewer and record the date forwarded to the reviewer and the forwarding date for tax review.
- The person's name to whom the report is given for rework (if required) should be entered and the dates forwarded for tax and audit reviews of rework are recorded (if required).
- Other dates should be recorded through final release.

.12

**Report Guide Sheet**  
**(To be bound with the—colored copy of report)**

**Engagement Information**

Client \_\_\_\_\_ Date Due \_\_\_\_\_  
 Assignment Number \_\_\_\_\_ Assignment Name \_\_\_\_\_  
 Partner \_\_\_\_\_ Manager \_\_\_\_\_ In-Charge Accountant \_\_\_\_\_

____ Compiled Financial Statements	Period _____
____ Reviewed Financial Statements	Period _____
____ Audited Financial Statements	Period _____
____ Review of Interim Financial Information	Period _____
____ Special Reports—Description:	Date _____

**Delivery Instructions:**

Name—attention of: \_\_\_\_\_ Mail \_\_\_\_\_  
 Address: \_\_\_\_\_ Delivery by: \_\_\_\_\_  
 \_\_\_\_\_

**Hold Items**

	Cleared by	Date
____ Attorney Letter	_____	_____
____ Letter of Representation	_____	_____
____	_____	_____
____	_____	_____

**Report Review:**

	Signature	Date
Prepared by	_____	_____
Manager	_____	_____
Review Department	_____	_____
Tax Department	_____	_____
Partner	_____	_____

**Report Processing:**

	Signature	Date
Typing Department	_____	_____
Comparing and Proofing	_____	_____
Final Reading	_____	_____

**Final Release:**

The report(s) described above were released by me after all hold items were cleared. All appropriate levels of review were signed off, and all processing steps completed.

\_\_\_\_\_  
 Signature

\_\_\_\_\_  
 Date

**Report Guide Sheet (continued)**

Report Description (Exactly as it will appear):

- ☐ Financial Statements and Accountant's Report (Compilation) (Review) Report  
☐ Financial Statement and Independent Auditor's Report  
☐ Unaudited (Interim) Financial (Statements) (Information) (and Accountant's Review Report)  
☐ Other Title

\_\_\_\_\_

\_\_\_\_\_

Client \_\_\_\_\_ Date \_\_\_\_\_

Report Production:

Covers: ☐ Printed ☐ Typed

Report Copies:

In covers

Client	_____	_____	_____	_____	_____
File	_____	_____	_____	_____	_____
Other	_____	_____	_____	_____	_____

<u>Uncovered</u>	<u>Workpaper copies (at least two)</u>	<u>Extra file copies</u>
------------------	--	--------------------------

Working Paper	_____	_____
Extra	_____	_____

Other Production Instructions:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_



## 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.

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[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 (SSARs) include citation of the particular source and its location in *AICPA Professional Standards*.

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# AAM Section 10,100

## *Format of Accountants' Reports*

### Report Preparation

.01 Firms should develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies:

- *Letterhead.* The report should be presented on firm letterhead.
- *Addressee.* The report should be addressed to the board of directors, stockholders, partners, general partner, proprietor, or to the company whose financial statements are being audited. If the firm was engaged by others, the report should be addressed thereto.

The Board of Directors  
XYZ Credit Union  
City, State Zip Code

- *Salutation.* A salutation should not be included on the report.
- *Report signing.* The firm name should be manually signed by the engagement partner. The words "Certified Public Accountants" should be excluded from the signature if they are a normal part of the firm's letterhead.
- *Report dating.* Audit reports should be dated as of the last day of field work.
  - The date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

City, State  
April 5, 199Y

- If significant subsequent events are discovered before the report is issued, but after the completion of field work, the report should be dual-dated for the subsequent event.
- Subsequent events affecting previously issued reports that are being reissued will also cause the report to be dual-dated. The following illustrates dual-dating:

City, State  
February 26, 199Y, except for Note X as to which the date is  
April 5, 199Y

- *Level of service.* The level of service performed and the nature of the report are typically outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, such as, in the event of a step-up or step-down in the level of service.
  - The partner should approve any step-up or step-down in level of service. A step-up in level of service may occur after obtaining a revised understanding with the client. A step-down in level of service should occur only after carefully evaluating the reasons for the change because the reasons for the change may also affect the report on lower levels of service. Limitations on the scope of an audit, for example, may also preclude issuing a review or compilation report.

- If more than one level of service is performed for financial statements of the same period (e.g., compilation and audit), the financial statements need only be accompanied by the report on the highest level of service performed.

## Reports on Audited Financial Statements

.02 Generally accepted auditing standards (GAAS) establish reporting responsibilities. The four standards of reporting stated in AU section 150.02 are:

- a. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
- b. The report shall identify those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.
- c. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
- d. The report shall contain either an expression of opinion regarding the financial statements taken as a whole, or a statement that an opinion cannot be expressed. When an opinion cannot be expressed, the reasons should be stated. In all cases, the report should contain a clear-cut indication of the degree of responsibility, if any, the auditor is taking.

## Standard Report

.03 The standard auditor's report prescribed by SAS No. 58, *Reports on Audited Financial Statements*, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58*, Reports on Audited Financial Statements (AU section 508), should be used when the auditor has formed an opinion, based on the application of GAAS, that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in accordance with GAAP. It should address all financial statements presented. A standard auditor's report for the presentation of comparative financial statements is illustrated in AAM section 10,210.010.

## Modifications of the Standard Auditor's Report

.04 SAS No. 58 (AU section 508), as amended, describes situations that may require auditors to modify the standard report, and also provides illustrations of the appropriate modifying language. These modifications, which are discussed in greater depth in the following sections, are:

- *Explanatory language.* A wide variety of situations may arise that require a modification of the standard auditor's report, without affecting the expression of an unqualified opinion. Some of the more common of such situations are going-concern problems, part of the financial statements have been audited by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor's opinion should be placed after the opinion paragraph.
- *Qualified opinion.* Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified opinion on the financial statements. Financial statements containing a material departure from GAAP, including inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require that an explanatory paragraph, preceding the opinion paragraph, be included that describes the nature of the scope limitation or the departure from GAAP.



- **Disclaimer of opinion.** A disclaimer of opinion may be required when:
  - The scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. In this case, an explanatory paragraph, preceding the disclaimer paragraph, should be included in the auditor's report to explain all significant reasons for the disclaimer.
  - The auditor is not independent, in which case a one-paragraph disclaimer is issued (applies for publicly held entities only). A compilation report with a lack of independence noted should be issued for nonpublic entities.
- **Adverse opinion.** An adverse opinion should be expressed on financial statements that do not present fairly the entity's financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are *not* fairly presented in accordance with GAAP. Issuance of an adverse opinion requires inclusion of an explanatory paragraph, preceding the opinion paragraph, that explains all of the reasons for the adverse opinion and, if practicable, the effects of the subject matter of the adverse opinion on the financial statements.

## Scope Limitations

.05 Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient, competent evidential matter, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors should be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected.

## Departures From GAAP

.06 **Unacceptable Principles.** Significant departures from GAAP require that the auditor issue either a qualified or adverse opinion. Choosing between a qualified or adverse opinion depends on the magnitude of the departure. While the materiality of the effects of the departure is a primary consideration, the auditor should also consider the pervasiveness of the departure, such as the number of financial statement items affected, the importance of the departure to the organization's activities and its ability to obtain funding, and the dollar effect of the departure on individual financial statement items as well as the statements as a whole.

.07 For both qualified and adverse opinions, an explanatory paragraph should be included, preceding the opinion paragraph, that describes all of the substantive reasons for the auditor's opinion, and the effects on the financial statements, if readily determinable. If it is not practical to determine the effects of the departure, the explanatory paragraph should contain a statement to that effect. If information about the effects of the departure are described in the notes, the explanatory paragraph can be shortened by referring to the note.

.08 **Inadequate Disclosure.** Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements. Such situations require the auditor to add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate.

.09 **Report Modification.** The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words "except" or "exception" and a reference to the explanatory paragraph that describes

that departure. Adverse opinions should include language such as "do not present fairly" and should also include a reference to the explanatory paragraph. A qualified opinion indicating a departure from GAAP is presented in AAM section 10,240.020. An adverse opinion indicating a departure from GAAP is presented in AAM section 10,220.01.

## Errors, Fraud, and Illegal Acts

.10 If the financial statements are materially affected by an error, fraud or illegal act that has not been properly accounted for and disclosed, a qualified or adverse opinion should be considered. If the auditor is precluded from applying necessary procedures or from obtaining sufficient information to conclude whether an error, fraud or illegal act that could be material to the financial statements has occurred, a qualified or disclaimer of opinion should be issued. All such matters should be discussed immediately with the engagement partner.

.11 If a client will not accept modification of the report under the circumstances above, the firm should consider withdrawing from the engagement and consulting with legal counsel.

## Consistency Exceptions

.12 Accounting changes affecting consistency include:

- A change from one generally accepted accounting principle to another method, practice or principle that is different from the one previously used.
- A change from an unacceptable to an acceptable principle (correction of an error).
- A change in financial statement classification that significantly affects financial position or results of operations (e.g., classification of an item in earnings from operations as other income or expense).
- A change in reporting entity.

.13 Accounting changes not normally affecting consistency include:

- Initial adoption of an existing accounting principle for a new event or transaction.
- Insignificant reclassification.
- Correction of errors not involving a principle.
- Changes in accounting estimates.

.14 The nature of the accounting change will determine whether prior periods should be restated or a cumulative adjustment should be included in current activities. In either event, the change should be disclosed in the notes to the financial statements and in the auditor's report in a separate paragraph following the opinion paragraph. The auditor's concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or a prospective change of a principle requiring retroactive adjustment is not discussed. In such situations, either a qualified or adverse opinion should be issued.

## Uncertainties

.15 Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because

they can result in a qualified or adverse opinion due to a departure from GAAP, or a qualified opinion or disclaimer due to a scope limitation. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5, *Accounting for Contingencies* (AC C59), and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

**.16 *Uncertainties Not Requiring Modification of the Opinion.*** SAS No. 58, paragraph 29, as amended by SAS No. 79 (AU section 508.29), states that when the auditor has concluded that sufficient information supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

**.17 *Scope Limitations.*** A qualified opinion or disclaimer of opinion may be required if the auditor is unable to obtain sufficient information to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements. In some ways, information about uncertainties may always be considered insufficient because it is dependent on future, unknown events. However, if the auditor determines that information did or does exist, but it is unavailable to him or her (e.g., because the information was destroyed or management will not allow the auditor to have access to it), the auditor should consider modifying the report for a scope limitation.

**.18 *Departures From GAAP.*** SAS No. 58, paragraph 45, as amended by SAS No. 79 (AU section 508.45), describes three categories of departures from GAAP involving risks or uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

**.19** A qualified or adverse opinion due to a departure from GAAP may be necessary if the auditor concludes that a matter involving an uncertainty has not been appropriately disclosed in the financial statements in conformity with GAAP.

**.20** Also, a departure from GAAP may exist if management has made inappropriate estimates of future events in applying accounting principles (such as the use of unreasonable expected lives of depreciable assets for calculating depreciation) or in making other accounting estimates.

**.21 *Going-Concern Uncertainties.*** If the auditor concludes that there is substantial doubt about the organization's ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph should describe the principal events and conditions related to the going concern, their possible effects on the financial statements, management's plans for corrective actions, and the auditor's conclusion that substantial doubt exists. SAS No. 64, *Omnibus Statement on Auditing Standards—1990* (AU section 341.12 and .13), imposes the additional requirement that the explanatory paragraph include the terms "substantial doubt" and "going concern." The auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern in the going-concern explanatory paragraph.

**.22** If financial statement disclosures about the uncertainty are inadequate, a departure from GAAP exists, and either a qualified or adverse opinion may be necessary.

## Reporting on Supplementary Information

**.23** Supplementary information includes detailed schedules of other data that are not necessary for a fair presentation of the basic financial statements. Whenever supplementary information is included in an auditor-

submitted document, the auditor must indicate the degree of responsibility, if any, taken for this information. A separate report on the supplementary information or a separate paragraph in the report on the basic financial statements may be used to report on supplementary information. If a separate report is issued, it should be on the firm's letterhead and be signed. The report date should be the same as for the basic financial statements.

.24 Reports on supplementary information should express or disclaim audit assurance. The extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. If a separate report on the supplemental information is issued, the first sentence of that report should refer to the report on the basic financial statements.

## Reporting on a Single Statement

.25 In certain circumstances, an engagement to audit a single financial statement may be accepted. Generally these engagements, called "limited reporting engagements," are a result of the client needing a single financial statement to fulfill a contractual requirement, such as an organization that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the statement of financial position only for the first year, with the intention of having audits of the entire financial statements in the future. Generally such engagements are accepted as long as there is a legitimate reason for the limited engagement, and provided there are no restrictions on access to information underlying the financial statements or on the scope of the procedures the auditor needs to perform. In such engagements, an unqualified opinion can be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion should be issued on those statements. An unqualified opinion on a single statement audit is presented in AAM section 10,210.030.

## Relying on the Work of a Specialist

.26 The firm may engage specialists to perform certain work supporting representations in the financial statements. SAS No. 73, *Using the Work of a Specialist* (AU section 336), says if a review of the specialist's work finds it satisfactory, and if no report modification is necessary because of the specialist's findings, there is no need to refer to the specialist's work.

.27 If the specialist's work is not adequate to support the financial statement representations, a qualification or disclaimer of opinion because of a scope limitation may be required. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may require a qualified or adverse opinion.

## Lack of Independence

.28 For public entities, whenever the auditor is not independent with respect to a client whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm may only issue a compilation report that includes a statement that the firm is not independent.

## Reissuance of Audit Reports as Predecessors

.29 If the auditor is asked by a former client to reissue its report on prior-period financial statements, he or she should inform the client of the procedures necessary to comply with that request. If the client agrees to perform these procedures, and pay the fee for these services, the auditor would ordinarily agree to reissue the report.

.30 Before reissuing a report, the auditor should consider whether the previous opinion on those prior-period statements is still appropriate. Differences in the current form and presentation of the financial statements for the prior period, or the possibility of material subsequent events affecting those financial statements, could make the previous opinion inappropriate. The auditor should perform at least the following procedures:

- Read the financial statements of the current period.
- Compare the prior-period financial statements with the financial statements to be presented in comparative format by the successor.
- Obtain a letter of representation from the successor auditor. The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior-period financial statements.

.31 If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual-dated as to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

## Reissuance of the Audit Report Subsequent to the Date of Original Issue<sup>1</sup>

.32 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner is necessary to reissue a previously issued report. In such situations the engagement partner may prepare a memo stating the reasons for the reissuance and that he or she is not aware of any circumstances occurring since the original report date that would require adjustment to or disclosure in the financial statements.

.33 Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the auditor has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner should consider a brief discussion with the client's chief financial or executive officer before reissuing his or her report.

## Subsequent Discovery of Facts Existing at Report Date

.34 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The engagement partner should make inquiries of client management in this regard.

.35 If the information is reliable and did exist at the date of the report, if the report would have been affected if the information had been known at the report date, and if there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures should be made in one of the following ways:

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<sup>1</sup> 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.

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[The next page is 10,211.]

# AAM Section 10,210

## *Unqualified Opinions*

### .010 Auditor's Standard Report—Comparative Financial Statements

#### Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 8, as amended by SAS No. 79 (AU section 508.08).]

**.020 Auditor's Standard Report—Single Year Financial Statements****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 8, as amended by SAS No. 79 (AU section 508.08).]



**.030 Report on a Single Statement Audit (Balance Sheet Only Presented) [Assuming the auditor is able to satisfy himself or herself regarding the consistency of application of accounting principles]**

**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).]

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**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).]

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**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).]

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**.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).]

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**Note:** If the predecessor's report was issued before February 29, 1996 (the effective date of SAS No. 79 [AU section 508]) and contained an *uncertainties* explanatory paragraph, a successor auditor's report issued or reissued after the effective date of SAS No. 79 (AU section 508) should not make reference to the predecessor's previously required explanatory paragraph.

[Source: SAS No. 58, paragraph 74, footnote 28, as amended by SAS No. 79 (AU section 508.74).]

**.070 Reference to Other Auditors—Successor Auditor's Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor's Report**

**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).]

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\* 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).]

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**Note:** This report is used when the auditor concludes that he or she cannot serve as principal auditor for the restated financial statements.

**.083 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 19X1, were audited by other auditors who have ceased operations and whose report dated March 31, 19X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 19X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 (AU section 508.74).]

**.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).]

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\* 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.



**.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).]

**.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).]

**.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 depreciation 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).]

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**Note:** In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

**.110 Liquidation Basis of Accounting—Single Year Financial Statements****Independent Auditor's Report****Addressee:**

We have audited the accompanying statement of net assets in liquidation of X Company as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of X Company as of December 31, 19X2, the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, and the results of its operations and its cash flows for the period from January 1, 19X2 to April 25, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the following paragraph.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

[Signature]

[Date]

[Source: Interpretation No. 8 of SAS No. 58 (AU section 9508.36).]

**.120 Liquidation Basis of Accounting—Comparative Financial Statements****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 19X2 to April 25, 19X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 19X2, and the related statement of changes in net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X1, and the results of its operations and its cash flows for the year then ended and for the period from January 1, 19X2 to April 25, 19X2, its net assets in liquidation, as of December 31, 19X2, and the changes in its net assets in liquidation for the period from April 26, 19X2 to December 31, 19X2, in conformity with generally accepted accounting principles applied on the bases described in the following paragraph.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 19X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 19X2 from the going-concern basis to a liquidation basis.

[Signature]

[Date]

[Source: Interpretation No. 8 of SAS No. 58 (AU section 9508.36).]

**.130 Comparative Financial Statements—Unqualified Opinion on the Current Year's Financial Statements With Disclaimer of Opinion on the Prior Year's Statements of Income, Retained Earnings, and Cash Flows**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 19X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 19X0, enter into the determination of net income and cash flows for the year ended December 31, 19X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 19X1.

In our opinion, the balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 19X2, present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the year ended December 31, 19X2, in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 67, as amended by SAS No. 79 (AU section 508.67).]

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**Note:** This report assumes that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.

**.140 Comparative Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated March 1, 19X2, we expressed an opinion that the 19X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 19X1 financial statements to conform with generally accepted accounting principles. Accordingly, our present opinion on the 19X1 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 69, as amended by SAS No. 79 (AU section 508.69).]



**.150 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Reviewed**

**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).]

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**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).]

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**Note:** When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

**.170 Comparative Financial Statements—Current Year's Statements Audited and Disclaimer on Prior Year's Unaudited Statements**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

The 19X1 financial statements were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

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**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]

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**Note:** The above illustrates a report as described in SAS No. 51, paragraph 10, as amended (AU section 534.10).

**.190 Report on Financial Statements Prepared in Conformity With the Accounting Principles Generally Accepted in Another Country That Will Have More Than Limited Distribution in the United States**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X to the financial statements, the Company has recorded fixed assets in excess of historical cost using appraised value as the basis for adjustment in accordance with accounting principles generally accepted in [name of country]. If the fixed assets had been recorded at historical cost, fixed assets and retained earnings would be decreased by \$XXX,XXX and \$XXX,XXX respectively, as of December 31, 19XX, and net income and earnings per share would be increased by \$X,XXX and \$X.XX respectively for the year then ended.

In our opinion, except for the effects of recording the fixed assets in excess of historical costs, discussed in the preceding paragraph, the financial statements present fairly, in all material respects, the financial position of International Company as of December 31, 19XX, and the results of its operations and its cash flows for the year then ended, in conformity with generally accepted accounting principles.

(Optional Paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of the International Company at December 31, 19XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in [name of country].

[Signature]

[Date]

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**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).]

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**Note:** This report would be used when the issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent so that disclosure is not delayed (SAS No. 1, section 561, paragraph .06b [AU section 561.06b]).

**.210 Subsequent Event Prior to Issuance of Auditor's Report****Independent Auditor's Report**

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note X to the financial statements, on March 1, 19X3, the Company entered into an agreement to sell Subsidiary A. This Subsidiary represents X% of the Company's total assets and X% of its revenues.

[Signature]

[Date]

[Source: SAS No. 58, paragraphs 8 and 19, as amended by SAS No. 79 (AU section 508.08 and .19).]

**.220 Reissued Report Due to Subsequent Discovery of Facts Existing at the Date of the Auditor's Report**

**Independent Auditor's Report**

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note 10 to the financial statements, the Company's 19X2 [*specify account corrected*] previously reported as \$XX,XXX should have been \$X,XXX. This discovery was made subsequent to the issuance of the financial statements. The financial statements have been restated to reflect this correction.

[*Signature*]

[*March 31, 19X3, except for Note 10, as to which the date is April 30, 19X3*]

[Sources: SAS No. 1, section 561, paragraph .06a and SAS No. 58, paragraph 8, as amended by SAS No. 79 (AU sections 561.06a and 508.08, respectively).]

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[*The next page is 10,271.*]



# AAM Section 10,220

## *Adverse Opinions*

### .01 Departures from GAAP

#### Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X to the financial statements, the Company carries its property plant, and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Generally accepted accounting principles require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from generally accepted accounting principles identified above, as of December 31, 19X2 and 19X1, inventories have been increased \$\_\_\_\_\_ and \$\_\_\_\_\_ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant, and equipment, less accumulated depreciation, is carried at \$\_\_\_\_\_ and \$\_\_\_\_\_ in excess of an amount based on the cost to the Company; and deferred income taxes of \$\_\_\_\_\_ and \$\_\_\_\_\_ have not been recorded, resulting in an increase of \$\_\_\_\_\_ and \$\_\_\_\_\_ in retained earnings and appraisal surplus of \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively. For the years ended December 31, 19X2 and 19X1, cost of goods sold has been increased \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of \$\_\_\_\_\_ and \$\_\_\_\_\_ have not been provided, resulting in an increase in net income of \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of X Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 60, as amended by SAS No. 79 (AU section 508.60).]

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[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).]

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\* Although the introductory paragraph of the standard disclaimer of opinion begins with "We were engaged to audit ..." and the scope paragraph of the report is omitted, SAS No. 58, paragraph 67, as amended by SAS No. 79 (AU section 508.67), shows that the introductory paragraph does not need to be modified nor does the scope paragraph need to be omitted when the disclaimed financial statements are with audited financial statements.

**.02 Inability to Obtain Sufficient Competent Evidential Matter Due to a Scope Limitation****Independent Auditor's Report**

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at \$\_\_\_\_\_ as of December 31, 19X2, and at \$\_\_\_\_\_ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 63, as amended by SAS No. 79 (AU section 508.63).]

**.03 Scope Limitation—Inventory and GAAP Departure—Capitalized Lease Obligations****Independent Auditor's Report**

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$\_\_\_\_\_ and \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_ and \$\_\_\_\_\_, and retained earnings by \$\_\_\_\_\_ and \$\_\_\_\_\_ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_ and earnings per share would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, for the years then ended.

The Company did not make a count of its physical inventory in 19X2 or 19X1, stated in the accompanying financial statements at \$\_\_\_\_\_ as of December 31, 19X2, and at \$\_\_\_\_\_ as of December 31, 19X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 19X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature]

[Date]

[Source: SAS No. 58, paragraphs 39 and 63, as amended by SAS No. 79 (AU section 508:39 and .63).]

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**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.

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[The next page is 10,371.]



# AAM Section 10,240

## *Qualified Opinions*

### **.010 Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer is Appropriate)**

#### **Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$\_\_\_\_\_ and \$\_\_\_\_\_ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of \$\_\_\_\_\_ and \$\_\_\_\_\_, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 26, as amended by SAS No. 79 (AU section 508.26).]

**.020 Departure from GAAP—Leases Not Capitalized****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$\_\_\_\_\_ and \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_ and \$\_\_\_\_\_, and retained earnings by \$\_\_\_\_\_ and \$\_\_\_\_\_ as of December 31, 19X2 and 19X1, respectively. Additionally, net income would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_ and earnings per share would be increased (decreased) by \$\_\_\_\_\_ and \$\_\_\_\_\_, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 39, as amended by SAS No. 79 (AU section 508.39).]



**.030 Departure from GAAP—Leases Not Capitalized—Pertinent Facts Disclosed in Note**  
**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, generally accepted accounting principles require that such obligations be included in the balance sheets.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 40, as amended by SAS No. 79 (AU section 508.40).]

**.040 Inadequate Disclosure—Omission of Disclosures****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 19XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by generally accepted accounting principles.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 42, as amended by SAS No. 79 (AU section 508.42).]

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**Note:** This report assumes the effects are such that the auditor has concluded an adverse opinion is not appropriate.

**.050 Inadequate Disclosure—Omission of Statement of Cash Flows****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company declined to present a statement of cash flows for the years ended December 31, 19X2 and 19X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by generally accepted accounting principles.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 44, as amended by SAS No. 79 (AU section 508.44).]

**.060 Change in Accounting Principle Without Reasonable Justification****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note X to the financial statements, the Company adopted, in 19X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with generally accepted accounting principles, in our opinion the Company has not provided reasonable justification for making this change as required by generally accepted accounting principles.

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 52, as amended by SAS No. 79 (AU section 508.52).]

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**Note:** If the change was from an accounting principle that is not generally accepted to one that is generally accepted it would be a correction of an error and would require recognition in the auditor's report as to consistency. However, because the middle paragraph contains all of the information required in an explanatory paragraph (following the opinion paragraph) as required by SAS No. 58, paragraphs 16–18, as amended by SAS No. 79 (AU section 508.16–.18), an explanatory paragraph is not required in this instance.

**.070 Change to an Accounting Principle Not in Conformity With Generally Accepted Accounting Principles**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of \$\_\_\_\_\_. In our opinion, the new basis on which land is recorded is not in conformity with generally accepted accounting principles.

In our opinion, except for the change to recording appraised values as described above, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 55, as amended by SAS No. 79 (AU section 508.55).]

**.080 More than One Reason—Qualified Opinion on Prior Year's Financial Statements With the Current Year Qualified for the Same Reason and an Additional Reason**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$\_\_\_\_\_ and \$\_\_\_\_\_ at December 31, 19X2 and 19X1, respectively, or its equity in earnings of that affiliate of \$\_\_\_\_\_ and \$\_\_\_\_\_, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

The Company has excluded, from property and debt in the accompanying 19X2 balance sheet, certain lease obligations that were entered into in 19X2, which in our opinion, should be capitalized in order to conform with generally accepted accounting principles. If these lease obligations were capitalized, property would be increased by \$\_\_\_\_\_, long-term debt by \$\_\_\_\_\_, and retained earnings by \$\_\_\_\_\_, as of December 31, 19X2. Additionally, net income would be increased (decreased) by \$\_\_\_\_\_ and earnings per share would be increased (decreased) by \$\_\_\_\_\_ for the year then ended.

In our opinion, except for the effects on the 19X2 and 19X1 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate 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).]

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[The next page is 10,421.]

# AAM Section 10,245

## *Information Accompanying Audited Financial Statements*

### .010 Omission of Supplementary Information Required by the FASB

#### Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The Company has not presented [*describe the supplementary information required by the FASB in the circumstances*] that the Financial Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[Signature]

[Date]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

**.015 Omission of Supplementary Information Required by the GASB****Independent Auditor's Report**

Addressee:

We have audited the accompanying general-purpose financial statements of City of Example, Any State as of and for the year ended December 31, 19XX. These general-purpose financial statements are the responsibility of City of Example, Any State management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State as of December 31, 19XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with generally accepted accounting principles.

The City of Example, Any State has not presented [*describe the supplementary information required by the GASB in the circumstances*] that the Governmental Accounting Standards Board has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[Signature]

[Date]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]



**.020 Material Departures From FASB Guidelines on Supplementary Information**  
**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [specifically identify the supplementary information] on page XX is not required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As result of such limited procedures, we believe that the [specifically identify the supplementary information] is not in conformity with guidelines established by the Financial Accounting Standards Board because [describe the material departure(s) from the FASB guidelines].

[Signature]

[Date]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

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**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).]

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**Note:** Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the GASB. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

**.030 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the FASB**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [specifically identify the supplementary information] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [state the reasons].

[Signature]

[Date]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

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**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).]

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**Notes:** Even though he or she is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in his or her report. [Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the GASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

**.040 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information  
Required by FASB**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by the Financial Accounting Standards Board. [*The auditor should consider including in his or her report the reason(s) he or she was unable to resolve his or her substantial doubts.*]

[Signature]

[Date]

[Source: SAS No. 52, paragraph 2 (AU section 558.08).]

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**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).]

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**Notes:** Even though he or she is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she describes the nature of any material departure(s) in his or her report. [Source: SAS No. 52, paragraph 2 (AU section 558.08).]

Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by the GASB. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 2 (AU section 558.10).] (See AAM section 10,245.060.)

**.050 Report on Accompanying Information****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]

[Date]

[Source: SAS No. 29, paragraph 12, as amended by SAS No. 52 (AU section 551.12).]

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**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).]

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**Notes:** The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.



**.070 Disclaimer on Part of the Accompanying Information (Not Audited)****Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX-YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "un-audited," 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).]

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**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).]

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**Note:** The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

**.090 Supplementary Information Required by the FASB Included in Auditor-Submitted Document**  
**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 19X2 and 19X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The [identify the supplementary information] on page XX is not a required part of the basic financial statements but is supplementary information required by the Financial Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[Signature]

[Date]

[Source: SAS No. 29, paragraph 15, as amended by SAS No. 52 (AU section 551.15).]

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**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).]

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**Notes:** The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted documents.

When supplementary information required by the GASB is presented outside the basic financial statements in an auditor-submitted document, the auditor should disclaim an opinion on the information unless he or she has been engaged to examine and express an opinion on it.

In certain circumstances, the auditor's report should be expanded in accordance with SAS No. 52, paragraph 2 (AU section 558.08). The illustrative reports at AAM section 10,245.010-.045 are assembled from illustrative reporting language in SAS No. 52, paragraph 2 (AU section 558.08).

**.100 Consolidating Information Not Separately Audited****Independent Auditor's Report**

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 19X2 and 19X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of [at] December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[Signature]

[Date]

[Source: SAS No. 29, paragraph 18, as amended by SAS No. 52 (AU section 551.18).]

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**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).]

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[The next page is 10,471.]

# AAM Section 10,250

## *Engagements to Report on Internal Control*

### .010 Accountant's Report When Expressing an Opinion Directly on the Effectiveness of an Entity's Internal Control as of a Specified Date

#### Independent Accountant's Report

We have examined management's assertion included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 19XX based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>2</sup>

[Source: SSAE No. 2, paragraph 44, as amended by SSAE No. 9 (AT section 400.44)]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

<sup>2</sup> For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

**.020 Accountant's Report on Management's Assertion About the Effectiveness of an Entity's Internal Control as of a Specified Date**

**Independent Accountant's Report**

We have examined management's assertion included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 19XX based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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 W Company maintained effective internal control over financial reporting as of December 31, 19XX is fairly stated, in all material respects, based on [*identify stated or established criteria*].<sup>2</sup>

[Source: SSAE No. 2, paragraph 45, as amended by SSAE No. 9 (AT section 400.45).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

<sup>2</sup> For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."



**.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 included in the accompanying [*title of management report*], that, except for the material weakness described below, W Company has maintained effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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.

[*Include sentence(s) describing the material weakness and its effect on the achievement of the objectives of the control criteria and a statement that the condition represents a material weakness.*] A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.<sup>2</sup>

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

[Source: SSAE No. 2, paragraph 49, as amended by SSAE No. 9 (AT section 400.49).]

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**Note:** If the practitioner's report on his or her examination of management's assertion about the effectiveness of the entity's internal control is included within the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report that describes the material weakness:

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on these financial statements.

[Source: SSAE No. 2, paragraph 54, as amended by SSAE No. 9 (AT section 400.54).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

<sup>2</sup> This description of a material weakness differs from the definition of material weakness discussed in AT section 400.35. Although a practitioner should consider the definition contained in AT section 400.35 when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report.

**.040 Adverse Opinion 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 included in the accompanying [*title of management report*], that, because of the effect of the material weakness described below, W Company has not maintained effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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.

[*Include sentence(s) describing the material weakness and its effect on the achievement of the objectives of the control criteria and a statement that the condition represents a material weakness.*] A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis.<sup>2</sup>

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 19XX, based on [*identify established or stated criteria*].

[Source: SSAE No. 2, paragraph 50, as amended by SSAE No. 9 (AT section 400.50).]

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**Note:** If the practitioner's report on his or her examination of management's assertion about the effectiveness of the entity's internal control is included within the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report that describes the material weakness:

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on these financial statements.

[Source: SSAE No. 2, paragraph 54, as amended by SSAE No. 9 (AT section 400.54).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

<sup>2</sup> This description of a material weakness differs from the definition of material weakness discussed in AT section 400.35. Although a practitioner should consider the definition contained in AT section 400.35 when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report.

**.050 Adverse Opinion on Management's Assertion About the Effectiveness of an Entity's Internal Control<sup>1</sup>**

We have examined management's assertion, included in the accompanying [*title of management report*] that, except for the material weakness described below, W company has maintained effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>2</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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, W Company did not maintain effective internal control over financial reporting as of December 31, 19XX based on [*identify established or stated criteria*].

[Source: SSAE No. 2, paragraph 52, as amended by SSAE No. 9 (AT section 400.52).]

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**Note:** If the practitioner's report on his or her examination of management's assertion about the effectiveness of the entity's internal control is included within the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report that describes the material weakness:

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 19XX financial statements, and this report does not affect our report dated [*date of report*] on these financial statements.

[Source: SSAE No. 2, paragraph 54, as amended by SSAE No. 9 (AT section 400.54).]

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<sup>1</sup> 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 an appropriate 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 nevertheless asserts that the entity's internal control is effective.

<sup>2</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its report, including the kinds of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

**.060 Qualified Opinion on the Effectiveness of an Entity's Internal Control, or Management's Assertion Thereon, Due to a Scope Limitation**

**Independent Accountant's Report**

We have examined management's assertion included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 19XX based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

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

Our examination disclosed the following material weaknesses in the design of 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.

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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, 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, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX based on [*identify established or stated criteria*].

[Source: SSAE No. 2, paragraph 56, as amended by SSAE No. 9 (AT section 400.56).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

**.070 Disclaimer of Opinion on the Effectiveness of an Entity's Internal Control, or Management's Assertion Thereon, Due to a Scope Limitation**

**Independent Accountant's Report**

We were engaged to examine management's assertion, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting.

[*Scope paragraph should be omitted.*]

[*Explanatory paragraph.*]

[*Include paragraph to describe scope restrictions.*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to the entity's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of the entity's internal control over financial reporting.

[Source: SSAE No. 2, paragraph 58, as amended by SSAE No. 9 (AT section 400.58).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

**.080 Unqualified Opinion on 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, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 19XX based on [*identify established or stated criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination. 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 the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other accountants.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX, based on [*identify established or stated criteria*].

[Source: SSAE No. 2, paragraph 60, as amended by SSAE No. 9 (AT section 400.60).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

**.090 Unqualified Opinion on the Effectiveness of a Segment of the Entity's Internal Control****Independent Accountant's Report**

We have examined management's assertion, included in the accompanying [*title of management report*], that W Company's retail division maintained effective internal control over financial reporting as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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, W Company's retail division maintained, in all material respects, effective internal control over financial reporting as of December 31, 19XX based on [*identify established or stated criteria*].

[Source: SSAE No. 2, paragraph 65, as amended by SSAE No. 9 (AT section 400.65).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

**.100 Unqualified Opinion About the Suitability of Design of the Entity's Internal Control****Independent Accountant's Report**

We have examined management's assertion, included in the accompanying [*title of management report*], that W Company's internal control over financial reporting is suitably designed to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX, based on [*identify stated or established criteria*].<sup>1</sup> Management is responsible for the suitable design of internal control over financial reporting. Our responsibility is to express an opinion on the design of internal control based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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, W Company's internal control over financial reporting is suitably designed, in all material respects, to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 19XX, based on [*identify established or stated criteria*].

[Source: SSAE No. 2, paragraph 67, as amended by SSAE No. 9 (AT section 400.67).]

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**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 use of this report.

When reporting on the suitability of design of the 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.

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.



**.110 Unqualified Opinion Based on an Examination of Management's Assertion on the Effectiveness of the Entity's Internal Control Based on Criteria Established by a Regulatory Agency That Did Not Follow Due Process**

**Independent Accountant's Report**

We have examined management's assertion, included in the accompanying [*title of management report*] that that W Company's internal control over financial reporting as of December 31, 19XX, is adequate to meet the criteria established by \_\_\_\_\_ agency, as set forth in its audit guide dated \_\_\_\_\_.<sup>1</sup> Management is responsible for maintaining internal control over financial reporting. Our responsibility is to express an opinion on whether the internal control is adequate to meet such criteria based on our examination.

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

Because of the inherent limitations in any internal control, misstatements due to error or fraud 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, W Company's internal control over financial reporting is adequate, in all material respects, to meet the criteria established by \_\_\_\_\_ agency, based on such criteria.

This report is intended for the information and use of the board of directors and management of W Company and [*agency*] and should not be used for any other purpose.<sup>2</sup>

[Source: SSAE No. 2, paragraph 70, as amended by SSAE No. 9 (AT section 400.70).]

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<sup>1</sup> The practitioner should identify the management report examined by referring to the title used by management in its report. Further, he or she should use the same description of the entity's internal control as management uses in its reports, including the types of controls (that is, controls over the preparation of annual financial statements, interim financial statements, or both) on which management is reporting. If the presentation of management's assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of management report*]" would be omitted.

<sup>2</sup> If the report is a matter of public record, the following sentence should be added:  
However, this report is a matter of public record and its use is not limited.

**.120 Communication of Internal Control 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 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. However, we noted certain matters involving the 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 or operation of the internal control 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) and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[Date]*

**THE AUDITOR SHOULD NOT ISSUE A REPORT REPRESENTING THAT NO REPORTABLE CONDITIONS WERE NOTED.**

[Source: SAS No. 60, paragraphs 12 and 17, as amended by SAS No. 87 (AU section 325.12 and .17).]

**.130 Communication of Internal Control 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 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. However, we noted certain matters involving the internal control 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 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 components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements 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 would not necessarily disclose all matters in internal control 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) and is not intended to be and should not be used by anyone other than these specified parties.

*[Signature]*

*[Date]*

**THE AUDITOR SHOULD NOT ISSUE A REPORT REPRESENTING THAT NO REPORTABLE CONDITIONS WERE NOTED.**

[Source: SAS No. 60, paragraphs 12, 16, and 17, as amended by SAS No. 87 (AU section 325.12, .16, and .17).]

**.140 Report on Controls Placed in Operation at a Service Organization**

To XYZ Service Organization:

We have examined the accompanying description of controls related to the (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 controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,<sup>1</sup> and (3) such controls 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 controls for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's controls, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of (*date*). Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

The description of controls at XYZ Service Organization is as of (*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 controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: SAS No. 70, paragraph 38 (AU section 324.38).]

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**Notes:** This report should have an attachment containing a description of the service organization's controls that may be relevant to a user organization's internal control.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

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 controls.

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<sup>1</sup> If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the controls contemplated in the design of XYZ Service Organization's controls" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

**.150 Report on Controls Placed in Operation at a Service Organization and Tests of Operating Effectiveness**

To XYZ Service Organization:

We have examined the accompanying description of controls related to the (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 controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,<sup>1</sup> and (3) such controls 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 controls that had been placed in operation as of (*date*). Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from (*date*) to (*date*). The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control at user organizations, when making assessments of control risk for user organizations. In our opinion the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from (*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.]<sup>2</sup>

The relative effectiveness and significance of specific controls at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at XYZ Service Organization is as of (*date*), and information about tests of the operating effectiveness of specific controls 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 specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

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<sup>1</sup> If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the controls contemplated in the design of XYZ Service Organization's controls" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

<sup>2</sup> This sentence should be added when all of the control objectives listed in the description of controls placed in operation are not covered by the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of controls placed in operation are included in the tests of operating effectiveness.

[Source: SAS No. 70, paragraph 54 (AU section 324.54).]

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**Notes:** This report should have two attachments: (a) a description of the service organization's controls that may be relevant to a user organization's controls and (b) a description of controls for which tests of operating effectiveness were performed, the control objectives the controls were intended to achieve, the tests applied, and the results of these tests.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

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 controls.

**.160 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. (the Company) for the year ended December 31, 19X1, we considered its internal control, including control activities 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 internal control.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including tests of compliance with such practices and procedures that we considered relevant to the objectives stated in rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(11) and the reserve required by rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications and comparisons, and the recording of differences required by rule 17a-13\*
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls, and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from 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. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control or the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate. Our consideration of internal control would not necessarily disclose all matters in internal control 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 components does not reduce to a relatively low level the risk that error or fraud 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

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\* If the broker or dealer is exempt from compliance with Rule 15c3-3, does not maintain customer accounts and does not handle securities this report should be modified as stated in the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, appendix E.

assigned functions. However, we noted no matters involving internal control, including control activities for safeguarding securities, that we consider to be material weaknesses as defined above.<sup>1</sup>

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 19X1, to meet the SEC's objectives.<sup>2</sup>

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [Designated self-regulatory organization], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm  
New York, New York  
February 15, 19X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix D.]

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**Note:** AAM section 10,650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

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<sup>1</sup> 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 activities, or control activities 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 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.]

<sup>2</sup> 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.



**.170 Letter to SEC When the Broker-Dealer Has Not Made the Required Notification**

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. (the Company) 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 ending, 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 as required by generally accepted auditing standards or (2) study the Company's practices and procedures relevant to the objectives stated in rule 17a-5(g) of the Securities and Exchange Commission as required by rule 17a-5.

The management of the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in internal control, errors or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily disclose all material weaknesses in internal control, including control activities for safeguarding securities.

However, pursuant to the requirements of rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc. and we believe the following additional information is required pursuant to the requirements of the rule.

*[List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.]*

Accounting Firm  
New York, New York  
December 10, 19X1

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix F.]

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**Note:** AAM section 10,650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

**.180 Independent Auditor's Report on Internal Control 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, including control activities 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 internal control.

Also, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices and procedures followed by the Corporation including tests of such practices and procedures that we considered relevant to the objectives stated in Regulation 1.16 in making the following:

1. The periodic computations of minimum financial requirements pursuant to Regulation 1.17
2. The daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations
3. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC.

The management of the Corporation is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the CFTC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the 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 accordance 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 internal control or the practices and procedures referred to above, errors or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of internal control would not necessarily disclose all matters in internal control 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 specific internal control components does not reduce to a relatively low level the risk that error or fraud 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

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\* SOP 98-8, *Engagements to Perform Year 2000 Agreed-Upon Procedures Attestation Engagements Pursuant to Rule 17a-5 of the Securities Exchange Act of 1934, Rule 17Ad-18 of the Securities Exchange Act of 1934, and Advisories No. 17-98 and 42-98 of the Commodity Futures Trading Commission*, provides guidance to practitioners in performing year 2000 agreed-upon procedures attestation engagements to meet the requirements of these SEC Rules and CFTC advisories. Readers performing such agreed-upon procedures engagements should refer to the full text of this SOP for guidance, including appendix E of the SOP, an illustrative report on internal control required under CFTC Regulation 1.16, modified to limit the scope of the report for the year 2000 issue.

internal control, including procedures for safeguarding customer and firm assets, that we consider to be material weaknesses as defined above.<sup>1</sup>

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the CFTC 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 CFTC's objectives.<sup>2</sup>

This report is intended solely for the use of the Board of Directors, management, the CFTC, and other regulatory agencies that rely on Regulation 1.16 of the CFTC and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm  
New York, New York  
February 15, 19X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix G.]

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[The next page is 10,521.]

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<sup>1</sup> 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 activities, or control activities 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 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.]

<sup>2</sup> 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, and SAS No. 87 (AU section 623.08).]

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**Note:** 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. Call the AICPA at (888) 777-7077 and ask for product number 006701, to order.

**.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, and SAS No. 87 (AU section 623.08).]

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**Note:** 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. Call the AICPA at (888) 777-7077 and ask for product number 006701, to order.

**.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 [name of regulatory agency] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 8, as amended by SAS No. 77, and SAS No. 87 (AU section 623.08).]

**.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 is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18, as amended by SAS No. 87 (AU section 623.18).]



**.050 Royalties**

(Report on one or more specified elements, accounts, or items of a financial statement)

**Independent Auditor's Report**

Addressee:

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 19X2, under the terms of a license agreement dated May 14, 19XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 19X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18, as amended by SAS No. 87 (AU section 623.18).]

**.060 Profit Participation<sup>1</sup>**

(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 is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18, as amended by SAS No. 87 (AU section 623.18).]

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<sup>1</sup> If a specified element, account, or item is, or is based upon, an entity's net income or stockholder's equity or the equivalent thereof (e.g., profit participation), the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

**.070 Report on Federal and State Income Taxes in Financial Statements<sup>1</sup>****(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, as amended by SAS No. 87 (AU section 623.18).]

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<sup>1</sup> 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.

<u>Bank</u>	<u>General Ledger Account Balances as of December 31, 19XX</u>
ABC National Bank	\$ 5,000
DEF State Bank	13,776
XYZ Trust Company—regular account	86,912
XYZ Trust Company—payroll account	5,000
	<u>\$110,688</u>

We found no exceptions as a result of the procedures.

**Accounts Receivable**

2. We added the individual customer account balances shown in an aged trial balance of accounts receivable (identified as exhibit A) and compared the resultant total with the balance in the general ledger account.

We found no difference.

3. We compared the individual customer account balances shown in the aged trial balance of accounts receivable (exhibit A) as of December 31, 19XX, to the balances shown in the accounts receivable subsidiary ledger.

We found no exceptions as a result of the comparisons.

4. We traced the aging (according to invoice dates) for 50 customer account balances shown in exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger. The balances selected for tracing were determined by starting at the eighth item and selecting every fifteenth item thereafter.

We found no exceptions in the aging of the amounts of the 50 customer account balances selected. The sample size traced was 9.8 percent of the aggregate amount of the customer account balances.

5. We mailed confirmations directly to the customers representing the 150 largest customer account balances selected from the accounts receivable trial balance, and we received responses as indicated below. We also traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents for customers from which there was no reply. As agreed, any individual differences in a customer account balance of less than \$300 were to be considered minor, and no further procedures were performed.

Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply. No exceptions were identified in 120 of the confirmations received. The differences disclosed in the remaining 20 confirmation replies were either minor in amount (as defined above) or were reconciled to the customer account balance without proposed adjustment thereto. A summary of the confirmation results according to the respective aging categories is as follows:

<u>Aging Categories</u>	<u>Accounts Receivable December 31, 19XX</u>		
	<u>Customer Account Balances</u>	<u>Confirmations Requested</u>	<u>Confirmation Replies Received</u>
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
	<u>\$300,000</u>	<u>\$172,000</u>	<u>\$102,000</u>

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 is not intended to be and should not be used by anyone other than these specified parties.

[Source: SAS No. 75, Appendix A, as amended by SAS No. 87 (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 is not intended to be and should not be used by anyone other than these specified parties.

[Source: SAS No. 75, Appendix A, as amended by SAS No. 87 (AU section 622.49).]

**.100 Compliance With Contractual Provisions (Separate Report)**

We have audited, in accordance with generally accepted auditing standards, the balance sheet of XYZ Company as of December 31, 19X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 19X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 19X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Source: SAS No. 62, paragraph 21, as amended by SAS No. 87 (AU section 623.21).]

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**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 is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 30, as amended by SAS No. 87.(AU section 623.30).]



**.120 Report on a Schedule of Gross Income and Certain Expenses to Meet Regulatory Requirements and to be Included in a Document Distributed to the General Public**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 19XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF Company) as described in Note X, and are not intended to be a complete presentation of the Apartments' revenues and expenses.

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 19XX, in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 26, as amended by SAS No. 87 (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 is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 26, as amended by SAS No. 87 (AU section 623.26).]

### **.130 Report on the Application of Accounting Principles**

#### **Introduction**

We have been engaged to report on the appropriate application of generally accepted accounting principles to the specific (hypothetical) transaction described below. This report is being issued to the ABC Company (XYZ Intermediaries) for assistance in evaluating accounting principles for the described specific (hypothetical) transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

#### **Description of Transaction**

The facts, circumstances, and assumptions relevant to the specific (hypothetical) transaction as provided to us by the management of ABC Company (XYZ Intermediaries) are as follows:

Prior to 19X1, ABC Company used the accelerated cost recovery method (ACRS) to depreciate fixed assets for financial reporting and income tax purposes. The number of years specified by ACRS for recovery deductions of the fixed assets did not fall within a reasonable range of the asset's useful life. ABC Company switched to the straight-line method of depreciating its fixed assets in the current year.

#### **Appropriate Accounting Principles**

The change in depreciation methods should be accounted for as a prior period adjustment in the current year's financial statements in accordance with FASB Statement No. 16, *Prior Period Adjustments*, paragraph 11 [AC A35.103]. Since the number of years specified by ACRS for recovery deductions of the fixed assets did not fall within a reasonable range of the asset's useful life, the ACRS method would not be considered a generally accepted accounting principle. According to APB Opinion 20, *Accounting Changes*, paragraph 13, [AC A35.104], "A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error for purposes of applying this Opinion."

#### **Concluding Comments**

The ultimate responsibility for the decision on the appropriate application of generally accepted accounting principles for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountants. Our judgment on the appropriate application of generally accepted accounting principles for the described specific (hypothetical) transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

[Source: SAS No. 50, paragraph 9 (AU section 625.09).]

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**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**

To the Board of Directors  
ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 19X2 and 19X1, and the related statutory statements of income and changes in 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [state of domicile],\* which practices differ from 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.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of ABC Insurance Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*, paragraph 9.15]

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[The next page is 10,571.]

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\* If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.

# 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).]

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**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).]

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**Notes:** The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

**.03 Disclaimer—Cash Basis Statements**

**(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)**

Addressee:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 7 (AU section 504.07).]

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**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).]

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**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.

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[The next page is 10,621.]



# AAM Section 10,280

## *Lack of Independence*

### .01 Disclaimer

Addressee:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1 and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 10 (AU section 504.10).]

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**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.)

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[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).]

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**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.

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[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<sup>1</sup>

#### 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).]

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<sup>1</sup> 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<sup>2</sup>****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).]

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<sup>2</sup> This report is appropriate if a statement naming the auditor and stating that condensed financial statements have been derived from audited financial statements is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency at least annually (See SAS No. 42, paragraph 7, footnote 6 [AU section 552.07]).

**.03 Review Report on Condensed Financial Statements****Independent Auditor's Report**

Addressee:

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 19X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 19X1 and 19X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with generally accepted accounting principles.

We have previously audited, in accordance with generally accepted auditing standards, the consolidated balance sheet as of December 31, 19X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 19X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 19X0, is fairly stated in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[Signature]

[Date]

[Source: SAS No. 42, paragraph 8, as amended by SAS No. 71 (AU section 552.08).]

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**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.

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[The next page is 10,751.]





# AAM Section 10,500

## *Reports on Personal Financial Statements*

### .01 Auditor's Standard Report

#### Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audits in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of *[date]* and the changes in their net worth for the *[period]* then ended in conformity with generally accepted accounting principles.

*[Signature]*

*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.13.]

**.02 Audit Report—Statement of Financial Condition Only****Independent Auditor's Report**

Addressee:

I (We) have audited the statement of financial condition of James and Jane Person as of [date]. This financial statement is the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on this financial statement based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the statements of financial condition. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall presentation of the statement of financial condition. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statement referred to above presents fairly, in all material respects, the financial condition of James and Jane Person as of [date] in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.13.]

**.03 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Adverse Opinion**  
**Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to \$XX,XXX (XX percent of total assets) as of *[date]* have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial condition of James and Jane Person as of *[date]* and the changes in their net worth for the *[period]* then ended.

*[Signature]*

*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.18.]

**.04 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Qualified Opinion**  
**Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to \$XX,XXX (XX percent of total assets) as of *[date]* have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion, those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, except for the effects of the valuation of assets determined by James Person as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of *[date]*, and the changes in their net worth for the *[period]* then ended in conformity with generally accepted accounting principles.

*[Signature]*

*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.17.]

**.05 Audit Report—Disclaim Opinion Because of Scope Limitation—Inadequate Records****Independent Auditor's Report**

Addressee:

I (We) was engaged to audit the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

Because James and Jane Person do not maintain certain accounting records and supporting documentation, and I was (we were) unable to apply adequate auditing procedures regarding the recording of transactions, the scope of my (our) work was not sufficient to enable me (us) to express, and I (we) do not express, an opinion on these financial statements.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.16.]

**.06 Audit Report—Scope Limitation—Inadequate Records****Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

Except as explained in the following paragraph, I (we) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

In my (our) opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had I (we) been able to determine that all assets and liabilities and changes in net worth were recorded in the financial statements, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial condition of James and Jane Person as of [date], and the changes in their net worth for the [period] then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.15.]

**.07 Audit Report—Income Tax Basis****Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of *[date]*, and the related statement of changes in net worth—income tax basis for the *[period]* then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with generally accepted auditing standards. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As described in Note X, these financial statements were prepared on the basis of accounting James and Jane Person use for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities of James and Jane Person as of *[date]*, and the changes in their net assets for the *[period]* then ended on the basis of accounting described in Note X.

*[Signature]*

*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.19.]

**.08 Accountant's Standard Compilation Report**

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

*[Signature]*

*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.03.]



**.09 Compilation Report—Statement of Financial Condition Only**

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying statement of financial condition and, accordingly, do not express an opinion or any other form of assurance on it.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.03.]

**.10 Compilation Report—Omission of Substantially All Disclosures**

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

James and Jane Person have elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the financial condition of James and Jane Person and changes in their net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.04.]

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**Note:** When personal financial statements omit substantially all disclosures and do not disclose that the assets are presented at their estimated current values and that the liabilities are presented at their estimated current amounts, the accountant should include the following sentence at the end of the first paragraph of his or her report:

The financial statements are intended to present the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.05.]

**.11 Compilation Report—GAAP Departure—Material Assets at Cost**

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

As disclosed in Note X to the financial statements, generally accepted accounting principles require that assets be presented at their estimated current values and that liabilities be presented at their estimated current amounts. James and Jane Person have informed me (us) that their investment in ABC Company is stated in the accompanying financial statements at cost and that the effects of this departure from generally accepted accounting principles on their financial condition and the changes in their net worth have not been determined.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.12.]

**.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.]

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**Note:** When personal financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the notes ordinarily would state the basis of presentation and describe how that basis differs from generally accepted accounting principles. [Source: Accounting and Review Services Interpretation No. 12 of SSARS 1 (AR section 9100.42).]

**.13 Compilation Report—Financial Statements Included in a Prescribed Form**

Addressee:

I (We) have compiled the *[identification of financial statements, including period covered and name of individual(s)]* included in the accompanying prescribed form, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

My (Our) compilation was limited to presenting in the form prescribed by *[name of body]* information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

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

*[Signature]*

*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.08.]

**.14 Accountant's Standard Review Report**

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

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

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

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.10.]

**.15 Review Report—Statement of Financial Condition Only**

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [date], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in this financial statement is the representation of James and Jane Person.

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

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

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.10.]

**.16 Review Report—GAAP Departure—Failure to Include a Provision for Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases**

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James Person.

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

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

Generally accepted accounting principles require that personal financial statements include a provision for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. The accompanying financial statements do not include such a provision and the effect of this departure from generally accepted accounting principles has not been determined.

*[Signature]*

*[Date]*

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.12.]



**.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 worth—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.]

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*[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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.04.]

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**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.

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*[Signature of Firm]*

*[City and State]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.05.]

**.03 Unqualified Opinion—Defined Contribution Profit-Sharing Plan****Independent Auditor's Report**

Addressee:

We have audited the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan as of December 31, 19X1 and 19X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 19X1 and 19X0, and the changes in net assets available for benefits for the year ended December 31, 19X1 in conformity with generally accepted accounting principles.

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[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 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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.08.]

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\* 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*. As noted in a nonenforcement policy, 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, 1997, and 1998. If a plan does not adopt all of the provisions of SOP 92-6, the auditor should consider the effect of this departure from GAAP on his or her report. See SAS No. 58, *Reports on Audited Financial Statements* (AU section 508.35–60). See AAM section 10,600.13 for an illustration of an auditor's adverse opinion in a full scope audit of a health and welfare benefit plan when the auditor concludes that the plan's financial statements taken as a whole are not fairly presented in accordance with GAAP because the financial statements do not present the postretirement benefit obligations in accordance with SOP 92-6.

**.05 Unqualified Opinion—Supplemental Schedules Required by ERISA and DOL Regulations****Independent Auditor's Report**

Addressee:

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of (*identify*) are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.12.]

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**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 10,600.07, .08, and .18.

**.06 Unqualified Opinion—Defined Benefit Pension Plan Prepared on the Modified Cash Basis****Independent Auditor's Report**

Addressee:

We have audited the accompanying statements of net assets available for benefits (modified cash basis) of XYZ Pension Plan as of December 31, 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. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.22.]

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**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. The Interpretation, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting" (AU sec. 9623.88), states that if cash, modified cash, or income tax basis financial statements contain elements, accounts,



or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations. Regardless of the basis of accounting used (GAAP or OCBOA), accumulated plan benefits disclosures should be made. If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or adverse opinion on the financial statements. [Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.23.]

[The next page is 10,807.]



**.07 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--.03.]*

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. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The 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.

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*[Signature of Firm]*

*[City and State]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.17.]

**.08 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–.03.]

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. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.17.]

**.09 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–.03.]*

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. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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*[Signature of Firm]*

*[City and State]*

*[Date]*

*[Source: AICPA Audit and Accounting Guide Audits of Employee Benefit Plans, paragraph 13.18.]*

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**\*\* 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 10,600.12.

**.10 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–.03.]

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. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, because of the omission of the information discussed in the preceding paragraph are not fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.18.]

**.11 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-.03.]*

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. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The 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.

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*[Signature of Firm]*

*[City and State]*

*[Date]*

*[Source: AICPA Audit and Accounting Guide Audits of Employee Benefit Plans, paragraph 13.18.]*

**.12 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. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.19.]



**.13 Adverse Opinion in a Full Scope Audit of a Health and Welfare Benefit Plan When the Auditor Concludes That the Plan's Financial Statements Taken as a Whole Are Not Fairly Presented in Accordance With GAAP Because the Financial Statements Do Not Present the Postretirement Benefit Obligations in Accordance With SOP 92-6**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying financial statements and supplemental schedules of ABC Multiemployer Health and Welfare Plan as of December 31, 19X2 and 19X1, and for the year ended December 31, 19X2, as listed in the accompanying index. These financial statements and schedules 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 to the financial statements, the Plan's financial statements do not present the plan's obligations to provide health and welfare benefits to participants after retirement (postretirement benefit obligations). Generally accepted accounting principles require that a Plan's statement of benefit obligations and statement of changes in benefit obligations include the postretirement benefit obligations.

The Plan administrator has not quantified the amount of, or change in, the Plan's postretirement benefit obligation, and in the absence of an actuarial determination, such amounts are not reasonably determinable. However, the effects of the omission of the postretirement benefit obligation information on the Plan's financial statements are presumed to be material.

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 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.

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. That information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2; however, because the basic financial statements are not presented fairly in conformity with generally accepted accounting principles, we do not express an opinion on any of the supplemental schedules.

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*[Signature of Firm]*

*[City and State]*

*[Date]*

[Source: AICPA Publication, *Financial Statement Reporting and Disclosure Practices for Employee Benefit Plans.*]

**.14 Limited-Scope Audits Under DOL Regulations****Independent Auditor's Report**

Addressee:

We were engaged to audit the financial statements and supplemental 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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.26.]

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**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 13.22 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 13.26, footnote 71.]

**.15 Limited-Scope Audit in Prior Year****Independent Auditor's Report**

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 19X2 and 19X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 19X2, and the statements of accumulated plan benefits as of December 31, 19X2 and 19X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 19X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan's 19X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of December 31, 19X1. The form and content of the information included in the 19X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 19X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 19X2, and changes in its financial status for the year then ended in conformity with generally accepted accounting principles.

Our audit of the Plan's financial statements as of and for the year ended December 31, 19X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) assets held for investment purposes, (2) loans or fixed income obligations, (3) leases in default or classified as uncollectible, (4) reportable transactions, and (5) non-exempt transactions as of or for the year ended December 31, 19X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 19X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.28.]

**.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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.29.]

**.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.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.30.]

**.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.

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*[Signature of Firm]*

*[City and State]*

*[Date]*

*[Source: AICPA Audit and Accounting Guide Audits of Employee Benefit Plans, paragraph 13.17.]*

**.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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.31.]

**.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. These supplemental schedules are the responsibility of the Plan's management. That additional information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.36.]



**.21 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. These supplemental schedules are the responsibility of the Plan's management. 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.

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*[Signature of Firm]*

*[City and State]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.40.]

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*[The next page is 10,851.]*

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\* If the financial statements are included in an SEC filing not subject to ERISA, the words "including the schedules of investments" would be added here. Additionally, the report would cover the required statements of changes in net assets available for plan benefits for each of the three years in the period ended December 31, 19X2.



# AAM Section 10,650

## *Reports on Financial Statements of Brokers and Dealers in Securities*

### **.01 Unqualified Opinion on Financial Statements and Supplementary Schedules Required by the SEC** **Independent Auditor's Report**

Addressee:

We have audited the accompanying consolidated statement of financial condition of Standard Stockbrokerage Co., Inc. and Subsidiaries (the Company) 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 that you are filing pursuant to rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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 at 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 Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix A.]

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**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 (the Company) 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 that you are filing pursuant to rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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 1 to the financial statements, investment securities not readily marketable amounting to \$10,730,685 (27 percent of stockholders' equity) at 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 the fair 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 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 Exchange Act of 1934. 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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix B.]

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\* 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.

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**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 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix C.]

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**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.

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[The next page is 10,901.]

# AAM Section 10,700

## *Reports for Investment Companies*

### .01 Unqualified Opinion on the Financial Statements

#### Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows\* for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows\* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

---

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.03.]

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**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.

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\* 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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.06.]

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\* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.



**.03 Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying statement of assets and liabilities, including the schedule of portfolio investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company) as of December 31, 19X4, and the related statements of operations and cash flows\* for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 19X4, and the results of its operations and cash flows\* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.07.]

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\* 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 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.

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[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 9.08.]

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[The next page is 11,001.]

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\* 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.

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[The next page is 11,101.]

# AAM Section 11,100

## *Quality Control—General*

### AICPA Requirements

.01 Article VI—*Scope and Nature of Services*—of the AICPA’s *Principles of Professional Conduct* (ET section 57), requires that “members 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 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, in AAM section 11,300, are sample quality control forms to aid practitioners in implementing a quality control system.

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[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.



.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:

- 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.

**.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<sup>1</sup>).
  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—

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<sup>1</sup> 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.**

**.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.



- 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.

- 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.

**.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

- 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.



**.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<sup>2</sup>).
  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—

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<sup>2</sup> 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—**

- 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.

- 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.

- 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.



**.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

- 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.

.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<sup>3</sup>).
  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.

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<sup>3</sup> 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.

**.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.



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.

- 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.

**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.

**.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.**



.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.**

**.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.

## 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.

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*[The next page is 11,301.]*

# AAM Section 11,300

## *Sample Quality Control Forms*

.01 In determining the need for—and the extent of—documenting the firm’s quality control policies and procedures, the size, structure, and nature of the practice should be considered. The quality control standards do not require documentation of the quality control system; however, documentation of the monitoring of compliance with the quality control system is required. Whenever a firm performs monitoring procedures, it should document them.

.02 To meet the requirement to document the monitoring of a firm’s quality control system, a small firm should set up a quality control system monitoring file to record its performance of the monitoring procedures. AAM section 11,300.24 contains an example of a summary control checklist a firm could use as the control document in such a file. Naturally, the form and content of the documentation are a matter of judgment. The extent of the documentation may vary from firm to firm based on firm size, number of offices, degree of authority allowed its personnel, nature and complexity of the firm’s practice, firm organization, and appropriate cost-benefit. Documentation of compliance with the firm’s policies and procedures must be retained long enough to enable those performing the firm’s monitoring procedures and peer review to evaluate its compliance with its system of quality control.

.03 Presented below is a sample quality control document for a sole practitioner with no professional staff and a sample quality control document for a multipartner, local, CPA firm. Also presented below are sample quality control forms. These sample documents and forms will help practitioners maintain documentation evidencing the monitoring of a quality control system.

### **.04 Sample Quality Control Document for a Sole Practitioner Without Professional Staff<sup>1</sup>**

#### **Independence, Integrity, and Objectivity**

##### ***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.**

1.1 A current edition of the AICPA’s *Professional Standards*, which contains the profession’s interpretations related to potential issues or situations related to independence, integrity, and objectivity, is maintained in my library.

1.2 A subscription to the AICPA’s *Journal of Accountancy* is maintained. The magazine is reviewed monthly for relevant pronouncements related to independence, integrity, and objectivity.

1.3 My per diem staff and I document our independence on each engagement on a program step maintained in the workpapers. In addition, my per diem staff completes an independence checklist (see AAM section 11,300.06) when they are hired. When completing the checklist, staff are made aware that the following financial or other relationships may be prohibited:

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<sup>1</sup> Per diem professionals are occasionally hired.

- a. Business relationships with clients or with nonclients that have investor or investee relationships with clients.
- b. Loans from client financial institutions.
- c. Family members in director, officer, manager or audit sensitive positions with client entities, including not-for-profit organizations.
- d. Past due fees for professional services.
- e. Accounting or advisory services that have evolved into situations where the CPA has assumed some of the responsibilities of management.
- f. Bookkeeping services to SEC clients.

1.4 Accounts receivable that are past due are reviewed monthly to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

1.5 In situations where another CPA firm audits segments of an engagement, the independence of that other CPA firm is confirmed for every reporting engagement using a standard form maintained in my library. (See AAM section 11,300.07.)

1.6 I communicate with the AICPA Ethics Division in resolving independence questions. A memorandum documenting the resolution of independence matters is prepared and retained. Per diem staff reviews and initials the memorandum, as appropriate.

## Personnel Management

### *Policy 1*

**I will maintain the degree of technical training and proficiency required in the circumstances.**

1.1 I evaluate the knowledge and expertise required to perform the engagement prior to accepting an engagement, and accept only those engagements that can be performed with professional competence.

1.2 Per diem staff are interviewed and their backgrounds are investigated to reasonably ensure the employment of people with qualifications adequate to perform engagements competently. (See AAM section 11,300.14 and .15.)

### *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.**

2.1 I am a member of the AICPA and the [state] CPA Society and participate in professional activities.

2.2 I have a professional development program in which I complete a minimum of 40 hours of formal continuing professional education each year in areas related to my practice. [Firms should determine the specific requirements of their State Board of Accountancy and other bodies, as appropriate.] A record of professional development hours is maintained, updated, and periodically reviewed. (See AAM section 11,300.16–.18.) The types of programs qualifying for the fulfillment of the forty-hour requirement include:

- a. Continuing professional education programs of the AICPA and the [state] CPA Society. These include sessions attended and (with written evidence of completion) video cassette/workbook, or workbook programs.
- b. College courses related to the profession.

2.3 I receive and review statements relating to current developments in accounting and auditing including statements and interpretations issued by the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees. Changes to professional standards are considered in developing my professional development program.

2.4 When per diem staff are utilized on an engagement, my background investigation into such staff includes a determination of whether they are in compliance with the professional education requirements of the AICPA and the [state] CPA Society [and other bodies as appropriate].

### Acceptance and Continuance of Clients and Engagements

#### *Policy 1*

**I will evaluate factors that have a bearing on management's integrity.**

1.1 I obtain and review available information, such as prior-year reports, internally generated financial statements, income tax returns, and credit reports, about a prospective client and its operations.

1.2 I obtain and review information about the nature and purpose of the services to be provided to the prospective client by making inquiries of client management.

1.3 I make inquiries about a potential client and its management to bankers, attorneys, credit services, and others having business relationships with the company.

1.4 I contact predecessor auditors, where applicable, and make inquiries in accordance with generally accepted auditing standards, including the nature of any disagreements. I document these communications and whether evidence of "opinion shopping" exists.

1.5 I obtain and evaluate information regarding management's integrity.

#### *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.**

2.1 Clients are evaluated at the end of specific periods or upon the occurrence of certain events to determine whether the relationship should be continued. Evaluations of existing clients are made:

- a. Every three years, unless the following conditions exist, in which case the evaluation is made annually.
  1. When significant changes in the client occur (such as change in ownership, senior personnel, directors, nature of business, or the financial stability of the client).
  2. When the client is delinquent in paying fees.

3. When the client operates in a specialized industry.
4. When the engagement requires a burdensome number of hours to complete.
5. When the client is in the development stage:
6. When there are changes in the nature or scope of the engagement, including requests for additional services.
7. When conditions arise that would have caused the firm to reject the client or engagement had such conditions existed at the time of initial acceptance.

2.2 I determine if the knowledge and expertise necessary to perform the engagement exists or if it can be reasonably obtained.

2.3 I evaluate the information obtained regarding the engagement and make the acceptance or continuance decision. The evaluation and conclusion are documented in a memorandum. (See AAM section 11,300.23.)

### *Policy 3*

**I will obtain an understanding with the client regarding services to be performed.**

3.1 All requirements set forth in professional standards are adhered to regarding obtaining an understanding with the client. Professional standards are maintained in my library and are reviewed as necessary.

3.2 An engagement letter is obtained for every engagement annually. This letter documents my understanding with the client regarding the services to be performed.

## **Engagement Performance**

### *Policy 1*

**I will plan engagements to meet professional and the firm's requirements.**

1.1 Every engagement will be planned in accordance with professional standards. Planning considerations will include:

- a. Developing or updating background information on the client.
- b. Obtaining an engagement letter.
- c. Reviewing prior financial statements and accountant's report.
- d. Using audit programs, as necessary.

### *Policy 2*

**I will perform, supervise, review, document, and communicate in accordance with the requirements of professional standards and the firm.**

2.1 Purchased practice aids (including audit programs, disclosure checklists, etc.) are utilized on all engagements. These practice aids are available, together with AICPA professional standards in my library.

2.2 Workpapers, checklists, and other practice aids are prepared on all engagements, in accordance with firm policy, to document the work performed in accordance with professional standards.



2.3 The following items are required to be documented in the workpapers on all engagements:

- a. Consideration of internal control in planning and performing the engagement.
- b. Assessment of control risk.
- c. Consideration of audit risk and materiality when planning and performing an audit.
- d. Audit sampling techniques.
- e. Consideration of fraud in the financial statement audit.
- f. Conduct of and degree of reliance placed on analytical procedures.

2.4 All engagement workpapers prepared by per diem staff are reviewed and initialed prior to issuing the report.

### ***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 complicated, unusual, or unfamiliar issues).**

3.1 A technical reference library is maintained, and I have made arrangements to use the libraries of other practicing CPAs. The AICPA library is also used.

3.2 When presented with a practice question or problem that I may lack the expertise to resolve, I refer to the AICPA's Technical Hotline.

3.3 I consult with other practicing CPAs based on the following factors:

- a. The materiality of the matter.
- b. My experience in a particular industry or functional area.
- c. Whether generally accepted accounting principles or generally accepted auditing standards in the area:
  1. Are based on authoritative pronouncements that are subject to varying interpretations.
  2. Are based on varied interpretations of prevailing practice.
  3. Have yet to be developed.
  4. Are under active consideration by an authoritative body.
  5. Have not previously been interpreted by the firm.

3.4 All consultations are documented, including all relevant facts and circumstances and references to professional literature used in the determination of the conclusion reached. This documentation is retained in the engagement workpapers.

## **Monitoring**

### ***Policy 1***

**I will consider and evaluate, on an ongoing basis, the relevance and adequacy of my quality control policies and procedures.**

1.1 Every year I evaluate the firm's quality control policies and procedures for compliance with professional standards. (See AAM section 11,300.24.) Ineffective policies and procedures are revised.

1.2 During the evaluation, I review administrative, personnel, and engagement files in order to obtain reasonable assurance that quality control policies and procedures are being complied with. Compliance with firm policies and procedures that are related to the other elements of quality control are improved.

#### ***Policy 2***

**I will consider and evaluate, on an ongoing basis, the appropriateness of my guidance materials and any practice aids.**

2.1 I keep abreast of recently issued authoritative pronouncements (see AAM section 11,300.26) and periodically evaluate my purchased practice aids to determine that they reflect new guidance. New practice aids are purchased every year to keep them up-to-date.

#### ***Policy 3***

**I will consider and evaluate, on an ongoing basis, the effectiveness of professional development activities.**

3.1 Every year I review my CPE records and determine whether the courses I took and the courses I plan to take are appropriate in consideration of the firm's practice.

3.2 Every year I review my CPE records to determine that I am in compliance with the requirements of the AICPA and my State Board of Accountancy:

#### ***Policy 4***

**I will consider and evaluate, on an ongoing basis, compliance with my policies and procedures.**

4.1 I perform timely postissuance reviews of selected engagements. (See AAM section 11,300.25.)

4.2 I summarize any findings noted on the postissuance reviews.

4.3 Areas which are identified as deficient are targeted for improvement on future engagements.

4.4 When deficiencies are identified, I review the related policies and procedures to determine if they should be modified, in light of the deficiencies.

4.5 On an ongoing basis, I review the firm's policies and procedures for independence, integrity, and objectivity, personnel management, acceptance and continuance of clients and engagements, and engagement performance.

### **.05 Sample Quality Control Document for a Multipartner Local CPA Firm**

#### **Independence, Integrity, and Objectivity**

##### ***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.**

1.1 The managing partner is responsible for resolving questions relating to independence matters and is available to provide guidance when needed.

1.2 A memorandum documenting the resolution of independence questions is prepared and retained by the managing partner. The other firm personnel involved in the questions review and initial the memorandum.

1.3 Written representations (see section 11,300.06) are obtained upon hire and annually from firm personnel by the administrative partner confirming that:

- They are familiar with and are in compliance with professional standards and the firm's policies and procedures regarding independence, integrity, and objectivity.
- Prohibited investments are not held and were not held during the period.
- Prohibited relationships do not exist.
- Transactions prohibited by the firm have not occurred.

1.4 The managing partner is responsible for the resolution of exceptions to the firm's independence policies and procedures.

1.5 The managing partner designates a partner to perform an annual review each July of the independence compliance files for completeness and the firm's independence policies and procedures for compliance with professional standards. A report of findings is presented to all the partners.

1.6 Accounts receivable that are past due are reviewed monthly by the managing partner to ascertain whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.

### ***Policy 2***

**Personnel will be familiar with policies and procedures relating to independence, integrity, and objectivity.**

2.1 The firm's library will maintain a subscription to the AICPA's *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.

2.2 Independence of mental attitude, integrity, and objectivity are emphasized during training sessions, in the supervision and review of engagements, and in the acceptance and continuance of clients.

2.3 In engagements involving employee benefit plans and in engagements involving nonattest services that could affect independence, any special implications attendant to those types of engagements are discussed in training sessions, during the acceptance and continuance of the client phase, and during the performance of the engagement.

2.4 The client list, which is updated and distributed to all professional personnel biannually, is reviewed by all partners and professional employees to ensure that they are aware of those entities to which our independence policies apply. The managing partner is responsible for maintenance and distribution of the list.

### ***Policy 3***

**Confirm the independence of another firm performing parts of an engagement, or when the firm acts as principal auditor.**

3.1 The form and content of the independent representation that is to be obtained from a firm that has been engaged to perform segments of an engagement is part of the firm's accounting and auditing manual. (See AAM section 11,300.07.)

3.2 An annual representation of independence should be obtained from an affiliate or associate on a repeat engagement.

## Personnel Management

### *Policy 1*

**Personnel who are hired will possess the appropriate characteristics to enable them to perform competently.**

1.1 The firm seeks to employ individuals who possess high levels of intelligence, integrity, honesty, motivation, and aptitude for the profession.

1.2 The firm normally employs college and business college graduates with a concentration in accounting as full-time and part-time members of our professional and paraprofessional staff.

1.3 Newly employed staff members are from the top half of their college class, unless other factors such as personal achievements, work experience, and personal interests indicate the likelihood of adequate professional development.

1.4 The firm requires a professional staff applicant to have the academic background that will enable him to meet the requirements to sit for the CPA examination administered by the (state) Board of Accountancy.

1.5 The approval of the managing partner is required before making an employment offer in atypical situations, such as hiring relatives of personnel or clients, rehiring former employees, or hiring clients' employees.

1.6 The background of new employees is appropriately investigated to reasonably insure the hiring of persons with acceptable qualifications. Background investigations include, but are not limited to, obtaining completed application forms, obtaining college transcripts, receiving personal references, and inquiring about any outstanding regulatory actions. (See AAM section 11,300.14.)

1.7 The administrative partner is responsible for managing the firm's personnel function. All applicants for positions at the firm are interviewed by him. Applicants for positions above entry level are interviewed and approved by the managing partner in addition to the administrative partner before an employment decision is made.

1.8 When applicants for a professional position in the firm are evaluated on their personal characteristics, such as integrity, competence, motivation, etc., the rating system and interview forms maintained in the Personnel Manual shall be utilized for all applicants. (See AAM section 11,300.15.)

### *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.**

2.1 On a quarterly basis all partners submit to the administrative partner a projection containing anticipated manpower requirements for engagements during the coming quarter for which they have client responsibilities. (See AAM section 11,300.08.) Such projections are detailed as to number and classification of individuals required and are supported by preliminary engagement time estimates. The administrative partner prepares a summary schedule of assignments to be made for approval by the partners.

2.2 For every engagement where the anticipated time exceeds five man-days, a time budget is normally prepared under the direction of the engagement partner at least two weeks prior to the scheduled commencement of field work. Time budgets for smaller engagements are prepared as considered necessary by the engagement partners. The budgets provide detail as to appropriate staff level and time required by function such as cash, accounts receivable, inventory, and so forth.

2.3 The engagement partner *considers* the following factors to achieve a balance of engagement manpower requirements, personnel skills, individual development, and utilization:

- 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.

### ***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.**

3.1 The administrative partner is responsible for the formulation and implementation of firm policy regarding the guidelines and requirements for the firm's professional development programs.

3.2 Each partner and professional employee is required to complete a minimum of \_\_\_\_ hours of continuing professional education each year. (Firms should consider the requirements of the AICPA, state boards of accountancy, and regulatory agencies in establishing the firm's CPE requirements.) Partners and professional employees will participate in courses that are relevant to their responsibilities.

3.3 Partners and professional personnel complete the record of professional development form and forward it to the administrative partner. The administrative partner is responsible for having the personnel files of every partner and professional employee updated to include a current record of hours of professional development completed. (See AAM section 11,300.16–.18.)

3.4 The types of courses qualifying for the firm's professional development program include:

- Continuing professional education programs of the AICPA and the (State) Society of CPAs. This includes both sessions attended and cassette/workbook or workbook programs.
- Other accredited courses related to the profession.

3.5 As part of their orientation, newly employed personnel are informed of their professional responsibilities and opportunities by the administrative partner.

3.6 Newly employed personnel with limited experience are sent to introductory level training sessions of the AICPA or the (state) CPA Society during their first year of employment with the firm.

3.7 Personnel are reimbursed for membership dues paid to the AICPA, the (state) Society of CPAs and the local chapter of the state society.

3.8 Personnel are encouraged to participate 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.

3.9 It is the responsibility of the administrative partner to distribute information about current developments in accounting, auditing, and independence requirements to all personnel who do not receive them directly. This distribution includes statements and interpretations issued by the Financial Accounting Standards Board, Governmental Accounting Standards Board, the AICPA Auditing Standards Board, and other AICPA technical committees.

3.10 Pronouncements relating to areas of specific interest, such as those issued by the Securities and Exchange Commission, Internal Revenue Service, and other regulatory agencies are distributed by the appropriate specialist to persons who have responsibilities in such areas.

3.11 The administrative partner, as the firm's lead technician, is responsible for maintaining an accounting and auditing manual containing firm policies and procedures on technical matters. Updates are prepared and issued to the staff as new developments and conditions arise.

3.12 The firm does not, at present, conduct formal in-house training programs other than in specialized areas. However, from time to time personnel participate in the training programs of the AICPA and (firm name) CPAs.

3.13 A library of staff training cassette/workbook programs published by the AICPA and (state) Society of CPAs is maintained by the administrative partner for self-study and reference purposes and is available to all personnel.

#### *Policy 4*

**Personnel selected for advancement will have the qualifications necessary to fulfill the responsibilities they will be called on to assume.**

4.1 The administrative partner is responsible for making advancement and termination recommendations, determining who conducts the evaluation interviews, documenting the results of the interviews, and maintaining appropriate records. The administrative partner also ensures that the appropriate evaluation forms maintained in the firm's Personnel Manual are utilized and that the evaluation is completed no later than one month after an individual completes his particular engagement. (See AAM section 11,300.19-.22.)

4.2 The responsibilities and requirements for evaluation at each level are enumerated in the firm's staff classification guidelines contained in the Personnel Manual. The administrative partner is responsible for identifying those responsibilities and requirements.

4.3 The firm's Personnel Manual provides the staff with information regarding the firm's advancement policies and procedures. The administrative partner issues updates from time to time to reflect changes made by the partnership in the policies and procedures.

4.4 Professional employees assigned to an engagement for a period in excess of five days must be evaluated by their immediate superior on the engagement by use of the appropriate evaluation form. These evaluation forms are reviewed with the employee at the end of the engagement and are approved by the engagement partner. (See AAM section 11,300.19.)

4.5 Personnel with the responsibility for the preparation of evaluations are counseled (at least annually) by the administrative partner to ensure that they understand the firm's objectives.

4.6 All professional employees receive an evaluation of their performance at least once a year. (See AAM section 11,300.22.) Such counseling interviews are conducted by the administrative partner. These evalua-

tions summarize the evaluations received on engagements during the year. The individual's progress, strengths, weaknesses, future objectives, and the firm's future objectives are among the items discussed. The interviews are documented in each individual's personnel file.

4.7 Annually, each partner completes a partner evaluation form evaluating each of the partners, including himself. The completed forms are submitted to the managing partner who summarizes and reviews them with each partner.

## Acceptance and Continuance of Clients and Engagements

### *Policy 1*

**The firm will evaluate factors that have a bearing on management's integrity.**

1.1 All professional personnel are informed annually of the firm's policies and procedures for accepting and continuing clients.

1.2 Available financial information regarding new and continuing clients will be obtained and reviewed. Such information may include annual reports, interim financial statements, reports to regulatory agencies, income tax returns, and credit reports. This information will be used in determining whether to accept or continue a client relationship.

1.3 Inquiries will be made of a client's or a potential client's bankers, attorneys, credit services, factors, and others having business relationships with the entity.

1.4 Predecessor auditors (if applicable) are contacted and inquiries are made in accordance with generally accepted auditing standards.

1.5 When deciding to accept a new client or continue an existing client relationship, an evaluation of the information obtained regarding management's integrity is made and documented. (See AAM section 11,300.23.)

### *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.**

2.1 The firm's independence and ability to adequately serve a potential or existing client are evaluated prior to acceptance or continuance. In evaluating the firm's ability, consideration is given to the requirements for technical skills, knowledge of the industry, and availability of qualified personnel.

2.2 Reevaluations of existing client relationships occur every three years, or annually if any of the conditions listed in 2.3 below exist.

2.3 Consideration is given to circumstances that would cause the firm to regard the engagement as one requiring special attention. These circumstances include:

- 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.
- Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and engagements for employee benefit plans.
- Engagements where the expected man-hour requirement exceeds 300 hours.

2.4 Procedures for acceptance of a new engagement or continuance of an existing engagement are as follows:

- 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.
- The engagement partner completes a client acceptance form and submits it to the managing partner for approval.
- The engagement partner signs a step in the planning program noting client continuance, and a client continuance form is completed if circumstances identified in 2.3 above exist.
- 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.

2.5 A review is made to ensure that acceptance of a new client or continuance of an existing client relationship would not violate applicable regulatory agency requirements and the Code of Professional Conduct of the AICPA and/or the (state) CPA Society.

### *Policy 3*

**The firm will obtain an understanding with the client regarding the services to be performed.**

3.1 A written engagement letter is obtained on all engagements. Additionally, all significant understandings with clients are to be obtained in writing.

3.2 Engagement letters for continuing clients should be updated every three years, unless significant changes (like those described in 2.2 above) to the engagement circumstances have occurred, in which case an annual engagement letter is required.

## **Engagement Performance**

### *Policy 1*

**Planning for engagements will meet professional, regulatory, and the firm's requirements.**

1.1 The firm maintains and provides its professional personnel with an Audit and Accounting Manual and various other practice aids. Professional personnel involved in the planning for an engagement will follow the planning procedures discussed in the Manual and practice aids and will follow the factors to be considered in the planning process, which are prescribed in the Manual and practice aids.

1.2 For all engagements (unless the manpower requirements are below five man-days), the in-charge accountant or manager reviews with the engagement partner the following documents from the prior year's files to help determine the current year's activities.



- Engagement letter.
- Time budget compared with actual time expended.
- Evaluation of internal control.
- Audit or work programs.
- Engagement memoranda.
- Financial statements and report.
- Management letters.
- Planning memorandum.

1.3 For all engagements (unless the manpower requirements are below five man-days), the in-charge accountant or manager submits to the engagement partner the following (as applicable) for his written approval:

- Engagement letter.
- Time budget.
- Preliminary evaluation of internal control.
- Audit or work programs.
- Planning memorandum.

1.4 The planning memorandum includes the following:

- Staffing requirements and the need for specialized knowledge.
- Consideration of the economic conditions affecting the client or its industry and their potential impacts on the conduct of the engagement.
- Consideration of risks and how they may affect the procedures to be performed.

### *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.**

2.1 Depending upon every individual's background in relationship to his assignment, varying degrees of supervision are provided by proper engagement staffing.

2.2 Every staff member receives an Accounting and Auditing Manual upon joining the firm and is responsible for the proper filing of updates as they are issued.

2.3 The form and content of all workpapers will adhere to the guidelines established in the firm's Accounting and Auditing Manual. Furthermore, all applicable checklists, questionnaires and other forms prepared and maintained by the firm will be utilized during an engagement.

2.4 The in-charge accountant and/or manager reviews and initials all working papers he did not prepare (including those prepared by a partner). The engagement partner reviews the overall engagement (initialing all working papers not reviewed by a manager and working papers dealing with difficult and complex subjects) including financial statements and the report. The engagement partner discusses with the in-charge accountant and/or manager any critical areas and unusual accounting matters encountered during the engagement. These discussions are documented by a memorandum to the working papers, when appropriate.

2.5 In certain circumstances (as described in the firm's policies and procedures manual) prior to the issuance of the financial statements and the auditor's report thereon, a second partner not otherwise associated with the engagement evaluates the appropriateness of financial statement disclosures and the report.

2.6 The manager and partner on the engagement, when reviewing the working papers, will determine that all of the work performed and all the reports and financial statements are complete and comply with professional standards and firm policy.

2.7 Differences of professional judgment within an engagement team are to be resolved by the engagement partner, and the managing partner, if necessary. The resolution of the matter must be documented in a memorandum to the working papers. If a member of the team continues to disagree with the resolution, he may disassociate himself from the resolution of the matter and will be offered the opportunity to document, in the working papers, that a disagreement still exists.

### *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).**

3.1 All personnel are advised of the firm's consultation policies and procedures. These policies and procedures are incorporated into the firm's Accounting and Auditing Manual.

3.2 A listing of certain areas or specialized situations, which because of the nature or complexity of the subject have been identified as requiring consultation, is updated semiannually by the administrative partner for inclusion in the Accounting and Auditing Manual. The following areas and situations receive special consideration in preparing the list:

- Application of newly issued technical pronouncements.
- Industries with special accounting, auditing, or reporting requirements, including unusually complex employee benefit plans.
- Emerging practice problems.
- Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made.
- Reissuance of a report, consideration of omitted procedures after a report has been issued or subsequent discovery of facts that existed at the time a report was issued.
- Filing requirements of regulatory agencies.

3.3 A technical reference library is maintained to assist personnel in resolving practice problems. The administrative partner is responsible for reviewing semiannually the library contents and making necessary additions to ensure that the library is up-to-date and includes material related to the clients served.

3.4 The engagement working papers includes all relevant facts, circumstances, professional literature used, and conclusions reached on an engagement.

3.5 A listing of firm designated specialists and their areas of expertise is updated semiannually and included in the Accounting and Auditing Manual.

3.6 The following procedures are used to resolve differences of opinion on practice problems:

- Differences of opinion between a professional employee and an engagement partner are brought before the appropriate designated specialist.

- If the specialist agrees with the engagement partner, the matter is resolved.
- If the specialist disagrees with the engagement partner and they are unable to agree on an appropriate resolution, the managing partner is consulted in order to resolve the matter.

3.7 The engagement partner is responsible for the preparation of a memorandum documenting the considerations involved in the resolution of differences of opinion. The original memorandum is filed with the engagement working papers and a reference copy without identification of the client is placed in the subject file maintained in the library. Any party to the discussion who disagrees with the conclusion has the option of preparing a memorandum and filing it with the working papers.

3.8 Supervisory personnel are encouraged to seek advice from partners and managers the firm has designated as specialists in particular areas when confronted with a situation in the specialist's area of expertise.

3.9 When expertise is not available within the firm, a practice question or problem is referred by the engagement partner to the AICPA's Technical Hotline or other outside expertise for consultation.

3.10 The firm maintains a consultation agreement with the local office of (firm name) CPAs to provide the firm with additional expertise. Inquiries to that firm are channeled through the administrative partner.

3.11 The results of outside consultation are reviewed by the engagement partner and the managing partner before a decision is reached on the matter in question. (See AAM section 11,300.12 and .13.)

3.12 The Accounting and Auditing Manual is used to inform personnel of documentation required and the responsibility for its preparation.

## Monitoring

### *Policy 1*

**The firm will consider and evaluate, on an ongoing basis, the relevance and adequacy of its quality control policies and procedures.**

1.1 Every year a partner and manager, not otherwise directly involved in firm administration, are appointed by the managing partner as a monitoring team to evaluate the firm's quality control policies and procedures for compliance with professional standards.

1.2 While monitoring the firm's quality control system, the partner and manager team obtain assurance that the firm's quality control policies and procedures and its audit methodology remain relevant and adequate. (See AAM section 11,300.24.) Among the factors to be considered when making that assessment are the following:

- Mergers and divestitures of portions of the practice.
- Changes in professional standards or other regulatory requirements applicable to the firm's practice. (See AAM section 11,300.26.)
- 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 client's methods of doing business.
- Changes in client's industries that impact their operations.
- Changes in applicable AICPA membership requirements.

1.3 Once a year, all professional personnel will be provided with a form describing their responsibilities for maintaining the firm's standards of quality in performing their duties. Personnel will read and sign the form.

1.4 In assessing the firm's quality control system, the partner and manager team will identify (as applicable) ineffective or inappropriate policies and procedures that require revision. Necessary improvements in compliance with the firm's policies and procedures that are related to the other elements of quality control will also be identified.

#### *Policy 2*

**The firm will consider and evaluate, on an ongoing basis, the appropriateness of its guidance materials and any practice aids.**

2.1 The partner and manager team described in 1.1 above will also review and evaluate the firm's practice aids, such as audit programs, forms and checklists, based on the issuance of new professional pronouncements.

2.2 A staff meeting of all professional personnel will be held once a month. New professional standards, regulatory requirements and related changes to the firm's practice aids will be discussed in order to keep personnel informed of such matters.

#### *Policy 3*

**The firm will consider and evaluate, on an ongoing basis, the effectiveness of professional development programs.**

3.1 The managing partner annually reviews the firm's professional development policies and procedures (including personnel participation records) to determine whether it is adequately meeting the firm's needs, providing for the professional growth of individuals, and meeting mandatory continuing education requirements. An annual report is made to the partners.

3.2 At the monthly staff meeting, professional personnel will be solicited for information about the effectiveness of the firm's training program.

#### *Policy 4*

**The firm will consider and evaluate, on an ongoing basis, compliance with its policies and procedures.**

4.1 The partner and manager team described in 1.1 above will be responsible for performing an annual review (see AAM section 11,300.25) of a cross-section of engagements using guidance prepared by the AICPA for performing inspection procedures. Engagements will be selected using the following criteria:

- Significant specialized industries with emphasis given to high-risk engagements.
- Engagements for employee benefits.
- First-year engagements.
- Level of service (audit, review, compilation, attest)
- All partners and other management personnel having accounting and auditing responsibilities.

4.2 The monitoring/inspection team will also review the following material for propriety, as part of their annual review:

- Correspondence regarding consultation on independence, integrity, and objectivity matters, and acceptance and continuance decisions.
- The resolution of matters reported by professional personnel on independence circularization forms.

4.3 The results of the annual monitoring and inspection procedures are summarized in a report, together with corrective actions planned or taken. This report is presented to the partners of the firm. The partners of the firm set forth any recommended changes to the firm's policies and procedures. This report is retained by the managing partner.

4.4 The results of the engagement reviews are discussed with the supervisory personnel responsible for the engagements.

4.5 The final results of the all monitoring activities are communicated to all professional personnel in the firm.

4.6 The managing partner has the responsibility to determine that planned corrective actions were taken and to report the extent of compliance to all partners.

**.06 Independence Checklist for Employees<sup>1</sup>**

**Note:** When a firm obtains a new client or provides a new service to an existing client, it should determine the independence of the firm and its personnel, as required by professional standards. This is not usually documented specifically, so the easiest way to do so is by annual or periodic *written* independence representations from all firm personnel. An example is shown below.

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.

	<u>Yes</u>	<u>No</u>
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 not-for-profit 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 client* that are your responsibility?	_____	_____

<sup>1</sup> Certain items on this form are reprinted from the *Journal of Accountancy*, Copyright © 1997 by AICPA.

\* Client. The enterprise with whose financial statements the member is associated.

I have read and understand the firm's Independence Policy and the independence requirements of the:

American Institute of Certified Public Accountants

[State] Board of Accountancy

[State] Society of Certified Public Accountants

Government auditing standards

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I have read the attached listing of the firm's accounting, auditing, and attestation clients. To the best of my knowledge and belief, I am independent in regard to all of the clients on the list as required by the applicable requirements listed above except as noted 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. If no exceptions, so state.)

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Signature

Date Reviewer's initials

Exceptions approved by

Location

**.07 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.

- |  | <u>Yes</u> | <u>No</u> |
|--|------------|-----------|
| 1. We are aware that <i>[Name of primary auditor]</i> has been engaged to audit the financial statements of <i>[Name of parent]</i> as of <i>[Date]</i> and for the <i>[period, e.g., year]</i> then ended.                      | _____      | _____     |
| 2. We are aware that <i>[Name of primary auditor]</i> plans to rely on our audit of the financial statements of <i>[Name of subsidiary or component]</i> as of <i>[Date]</i> and for the <i>[period, e.g., year]</i> 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 <i>[Name of both the parent and subsidiary or component.]</i>  | _____      | _____     |

\_\_\_\_\_  
Partner of other audit firm

\_\_\_\_\_  
Date

Reviewed by:

\_\_\_\_\_  
Partner of primary audit firm



**.08 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 \_\_\_\_\_

Estimated total hours:

Partner \_\_\_\_\_

Manager \_\_\_\_\_

Staff \_\_\_\_\_

Industry \_\_\_\_\_

Total \_\_\_\_\_

Can dates be adjusted? Yes \_\_\_\_\_ No \_\_\_\_\_ Explain \_\_\_\_\_

Can personnel be changed? Yes \_\_\_\_\_ No \_\_\_\_\_ Explain \_\_\_\_\_

Comments \_\_\_\_\_

Requested by \_\_\_\_\_ Date \_\_\_\_\_

Scheduled \_\_\_\_\_ Date \_\_\_\_\_

Assignment  
Manager

.09 History of Staff Assignments

NAME \_\_\_\_\_

CLIENT/ LOCATION	DATES		RESPONSIBILITY LEVEL	ASSIGNMENT DESCRIPTION				
	INTERIM	YEAR END		TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____



## 11 Scheduling Master Plan

MONTH OF \_\_\_\_\_

Staff member	Carry forward	Month assignments	Nonworking hours							Nonrecurring assignments				Hours for month		
			Vacation	Holiday	Prof dev.	Comp time	CPA exam	Admin	Other	Tax dept	Review dept	Other client #	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	XXXXXXXX	XX	XXXX	XX	(XX)
Evans	X	X	X	X	X	X						XXXXXXXX	XX	XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXXX	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



**.13 Consultation Worksheet**

DATE \_\_\_\_\_

CLIENT NAME \_\_\_\_\_

LOCATION \_\_\_\_\_

ENGAGEMENT (TYPE) \_\_\_\_\_

SUBJECT (QUESTION) \_\_\_\_\_

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CONSULTANT'S RESPONSE: (Cite Professional literature discussed and conclusion of consultant) \_\_\_\_\_

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FINAL RESOLUTION \_\_\_\_\_

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\_\_\_\_\_  
Senior/Manager\_\_\_\_\_  
Date\_\_\_\_\_  
Partner\_\_\_\_\_  
Date

.14

PRE-EMPLOYMENT APPLICATION					
NAME				DATE	
ADDRESS					
TELEPHONE NUMBER			SOCIAL SECURITY NUMBER		
POSITION APPLIED FOR					
FIRST CHOICE		SECOND CHOICE		MINIMUM SALARY REQUIRED: \$	
<input type="checkbox"/> Full Time <input type="checkbox"/> Permanent Part Time <input type="checkbox"/> Temporary <input type="checkbox"/> Summer Temporary					
REFERRED BY <input type="checkbox"/> Newspaper ad _____ <input type="checkbox"/> Agency _____ <input type="checkbox"/> Friend _____ <input type="checkbox"/> Other _____ <div style="display: flex; justify-content: space-between; font-size: small;"> <span>NAME</span> <span>NAME</span> <span>NAME</span> <span>NAME</span> </div>					
EDUCATIONAL BACKGROUND — <input type="checkbox"/> See Below <input type="checkbox"/> See Attached Resume					
	NAME & LOCATION OF SCHOOL	MAJOR COURSE	YEARS ATTENDED		YEAR GRAD.
			FROM	TO	
Elementary					
High or Vocational					
Business or Technical					
College					
Graduate					
ADDITIONAL SKILLS OR MACHINE KNOWLEDGE <input type="checkbox"/> See Below <input type="checkbox"/> See Attached Resume					

**Note:** See the AICPA MAP Handbook for an alternative.





## .15 Interview Report

[illegible]

**Note:** See the AICPA MAP Handbook for an alternative.

**.16 Record of Professional Development**

Name \_\_\_\_\_ Employee No. \_\_\_\_\_

**Out-of-Office Courses:**

	<u>Sponsor</u>	<u>Course description</u>	<u>No. of hours</u>	<u>Date completed</u>
1.	_____	_____	_____	_____
2.	_____	_____	_____	_____
3.	_____	_____	_____	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____
7.	_____	_____	_____	_____
8.	_____	_____	_____	_____
9.	_____	_____	_____	_____
10.	_____	_____	_____	_____

**In-House Programs:**

	<u>Instructor</u>	<u>Course description</u>	<u>No. of hours</u>	<u>Date completed</u>
1.	_____	_____	_____	_____
2.	_____	_____	_____	_____
3.	_____	_____	_____	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____
7.	_____	_____	_____	_____
8.	_____	_____	_____	_____
9.	_____	_____	_____	_____
10.	_____	_____	_____	_____

**.17 19XX Professional Development**

		<u>Summary (in hours)</u>			
		<u>In-house presentations</u>			
		<u>Developed in-house</u>	<u>Purchased programs</u>	<u>Outside courses</u>	<u>Total</u>
<b>Partners/Owners</b>					
1.	_____	_____	_____	_____	_____
2.	_____	_____	_____	_____	_____
3.	_____	_____	_____	_____	_____
		<u>In-house presentations</u>			
		<u>Developed in-house</u>	<u>Purchased programs</u>	<u>Outside courses</u>	<u>Total</u>
<b>Professional staff</b>					
1.	_____	_____	_____	_____	_____
2.	_____	_____	_____	_____	_____
3.	_____	_____	_____	_____	_____
4.	_____	_____	_____	_____	_____
5.	_____	_____	_____	_____	_____
6.	_____	_____	_____	_____	_____
7.	_____	_____	_____	_____	_____
8.	_____	_____	_____	_____	_____
<b>Paraprofessionals</b>					
1.	_____	_____	_____	_____	_____
2.	_____	_____	_____	_____	_____
3.	_____	_____	_____	_____	_____
4.	_____	_____	_____	_____	_____

**.18 19XX Professional Development****Summary (in dollars)**

	<b><u>Purchased programs for in-house use</u></b>	<b><u>Outside courses</u></b>	<b><u>Total</u></b>
<b>Partners/Owners</b>			
1. _____	\$ _____	\$ _____	\$ _____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
<b>Professional staff</b>			
1. _____	_____	_____	_____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
4. _____	_____	_____	_____
5. _____	_____	_____	_____
6. _____	_____	_____	_____
7. _____	_____	_____	_____
8. _____	_____	_____	_____
<b>Paraprofessionals</b>			
1. _____	_____	_____	_____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
4. _____	_____	_____	_____

**.19 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.

**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 V H G B N NA

Rating: ☐ ☐ ☐ ☐ ☐

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**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 V H G B N NA

Rating: ☐ ☐ ☐ ☐ ☐

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**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 V H G B N NA

Rating: ☐ ☐ ☐ ☐ ☐

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**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 V H G B N NA

Rating: ☐ ☐ ☐ ☐ ☐

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**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 V H G B N NA

Rating: ☐ ☐ ☐ ☐ ☐

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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 \_\_\_\_\_

.29

**JOB EVALUATION REPORT**  
 [For Assignments of Thirty (30) Hours or More]

Name \_\_\_\_\_  
 Location \_\_\_\_\_  
 Engagement \_\_\_\_\_  
 Assistant \_\_\_\_\_ In-Charge \_\_\_\_\_

Compared to Others in Peer Group						
A	A-	B+	B	B-	C+	C
SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY
NOT APPLICABLE						

**A. PERFORMANCE ON THE JOB****1. Technical Ability Demonstrated**

- a) The purpose of the audit procedures planned was understood . . . . .  
 b) Materiality was neither underestimated nor overestimated . . . . .  
 c) Accounting theory and current releases of the profession were applied correctly . . . . .  
 d) Federal and state income tax regulations were applied correctly . . . . .


**2. Working Paper Evidence**

- a) Documentation of work performance, including adequate indexing and cross referencing . . .  
 b) Sound explanations and conclusions . . . . .  
 c) Use of standard work papers . . . . .  
 d) Legibility . . . . .  
 e) Accuracy — absence of mathematical errors . . . . .


**3. Completing This Job**

- a) Meeting planned time estimates . . . . .  
 b) Completing reports and tax returns . . . . .  
 c) Following up the reviewer's comments and making the necessary changes . . . . .


**4. Client Reaction on This Job**

- a) Getting along with the client's employees . . . . .  
 b) Interest in the client's business . . . . .


**B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)****1. Effectiveness of Proper Planning**

- a) Extent that the scope of the work related to internal control . . . . .  
 b) Developing the work program . . . . .


**2. Utilizing Staff Effectively and Efficiently**

- a) Advance planning to minimize crises . . . . .  
 b) Efficient use of staff on the job . . . . .  
 c) On-the-job training of assistants . . . . .


**3. Meeting Deadlines**

- a) Completing the engagement in the planned time . . . . .  
 b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed . .


**4. The Product**

- a) Quality of report preparation, including adequate and informative disclosures . . . . .  
 b) Quality of the management advice recommendations . . . . .


**5. Practice Management**

- a) Extending service . . . . .  
 b) Ease of collecting for services performed . . . . .






**.22 Employee Annual Performance Appraisal**

Time Period Involved			<input type="checkbox"/> EXEMPT <input type="checkbox"/> NON-EXEMPT	
From	To			
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
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
<u>Quality of Work</u>					
Is work accurate, neat and clearly presented?	( )	( )	( )	( )	( )
Carefully planned, well organized and thorough?	( )	( )	( )	( )	( )
<u>Productivity</u>					
Is a good level of production maintained?	( )	( )	( )	( )	( )
Are deadlines met?	( )	( )	( )	( )	( )
Are pressure situations handled effectively?	( )	( )	( )	( )	( )
<u>Knowledge of Job</u>					
Does the individual know where to get information?	( )	( )	( )	( )	( )
Is the individual used as a source of information by others?	( )	( )	( )	( )	( )
<u>Communication</u>					
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?	( )	( )	( )	( )	( )
<u>Human Relations</u>					
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?	( )	( )	( )	( )	( )
<u>Need for Supervision</u>					
Can the individual be relied upon to get work done without close supervision?	( )	( )	( )	( )	( )
Does the individual take the initiative when appropriate?	( )	( )	( )	( )	( )
<u>Problem Solving</u>					
Does the individual collect the data needed to solve problems?	( )	( )	( )	( )	( )
Are problems solved quickly?	( )	( )	( )	( )	( )
Are solutions reasonable and accurate?	( )	( )	( )	( )	( )

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
<u>Problem Solving—cont'd</u>					
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?	( )	( )	( )	( )	( )
<u>Work Habits</u>					
Does the individual comply with the Institute's established work hours?	( )	( )	( )	( )	( )
Does the individual provide proper notification when absent from work?	( )	( )	( )	( )	( )
<u>Personal Development</u>					
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?	( )	( )	( )	( )	( )
<u>Supervisory Capabilities</u>					
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 &amp; 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

**.23 Client/Engagement Acceptance and Continuation Checklist<sup>3</sup>**

**Note:** Acceptance of a new client normally is of critical importance to a small firm. Depending on the type of industry and the services to be provided, accepting a new client can affect nearly all aspects of a firm's quality control system: Are the firm's library and practice aids adequate? Do personnel have appropriate CPE? Does the firm need an outside consultant? The best time to document the acceptance decision is when a new audit or attestation client or engagement is signed, using a form such as the one below.

Name of prospective client: \_\_\_\_\_

Address and Phone No.: \_\_\_\_\_

Name and title of contact at prospective client: \_\_\_\_\_

Form completed by: \_\_\_\_\_ Date: \_\_\_\_\_

**Instructions**

This form provides for information necessary to assess whether to accept a prospective client. The information should be obtained from discussions with the prospective client's management, bankers, attorneys, credit services, and if applicable current or former independent CPA, from reviewing the client's financial statements, regulatory agency reports, credit reports, and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

**Services and Reports Required**

1. Describe the service and reports requested. \_\_\_\_\_  
\_\_\_\_\_
2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. \_\_\_\_\_  
\_\_\_\_\_
3. What is the required completion date? \_\_\_\_\_
4. Describe any other services not requested for which there appears to be a need. \_\_\_\_\_  
\_\_\_\_\_
5. What is the preliminary estimate of hours to complete the engagement? \_\_\_\_\_
6. Has the client imposed any restrictions on the scope of the engagement that might preclude expression of an unqualified report? \_\_\_\_\_  
\_\_\_\_\_
7. Do we have the necessary expertise and staff to perform the engagement? (If not, how will we overcome this problem?) \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

<sup>3</sup> Certain items in this checklist have been reprinted from the *Journal of Accountancy*, Copyright © 1997 by AICPA.

**Industry Practices and Conditions**

8. In what industry does the company operate? \_\_\_\_\_  
\_\_\_\_\_
9. Describe any specialized tax or accounting practices applicable to the industry. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
10. Describe any economic, technological or competitive conditions or other recent developments in the industry that may affect the company's operations. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
11. Describe any special regulatory requirements applicable to the industry. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
12. Is the company in the development stage? \_\_\_\_\_  
\_\_\_\_\_

**Organization and Personnel**

13. Company's Legal Name: \_\_\_\_\_ Fiscal Year End: \_\_\_\_\_
14. Type of legal entity (Corporation, S Corporation, partnership, proprietorship, etc.): \_\_\_\_\_
15. List the major stockholders (partners or owners) of the company and their percentage of ownership. If applicable, obtain and attach a copy of the company's organization chart.

Name and (if applicable) Title

% Ownership

_____	_____
_____	_____
_____	_____

16. List the principal members of management.

Name and Title

Stated Qualifications (education, training, and experience)

_____	_____
_____	_____
_____	_____

17. Briefly describe any existing or contemplated employee bonus arrangement (individual, title, method of computation), stock option, or pension (profit sharing) plans that may affect the engagement.

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

18. List each location maintained by the company (including foreign locations, if any), the nature of the activity performed at each, and the approximate number of employees at each, i.e., plant, sales office, executive offices, etc.

Location

Activity

No. of Employees

_____	_____	_____
_____	_____	_____

19. Inquire about possible transactions with related parties that may affect the engagement.

Name of Related Party	Relationship	Type of Transaction

**Operations**

20. Describe the nature of the company's major assets and liabilities. \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
21. What are the company's sources of revenue and marketing methods? Describe major products, customers, etc.). \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
22. If the company is economically dependent on a major customer, name the customer and approximate percentage of total revenue generated by this customer. \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
23. Describe the components of cost of goods sold and the company's production process: \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
24. What are the major expenses of the company other than cost of goods sold? \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
25. Describe the company's compensation methods, i.e., salary , hourly wage, commissions, piece work, union scale, etc. \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
26. What are the company's major sources of financing, i.e., working capital loans, long term debt, leasing, equity, etc. Describe restrictive covenants on any loan agreements. \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
27. Is management sufficiently knowledgeable about its activities and financial condition? \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_
28. Does it appear that the entity's activities or resources are heavily concentrated in one or a few high-risk areas? \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_



**Accounting**

29. Does the company maintain the following items? [Attach description, if appropriate.]

- a. Accounting manual? \_\_\_\_\_
- b. Budget? \_\_\_\_\_
- c. Cost accounting system? \_\_\_\_\_
- d. Information technology? (indicate type of equipment and software) \_\_\_\_\_
- e. Written credit policy? \_\_\_\_\_

30. Briefly describe the accounting system and accounting responsibilities.

Description of Accounting Record	Name of Person Who is Responsible	Information Technology	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	_____	_____	_____	_____
_____	_____	_____	_____	_____

31. Describe the company's completeness procedures and methods to insure that accounting transactions enter into the accounting system, i.e., that all shipments or services are invoiced, that all cash sales are recorded, and that all disbursements are recorded. \_\_\_\_\_

32. Describe any unusual features of the accounting system. \_\_\_\_\_

33. Are sufficient records available to perform the engagement? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
34. Is management sufficiently knowledgeable about applicable accounting principles? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
35. Does management understand accounting matters adequately to assume responsibility for proper valuation, presentation, and disclosure? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

#### Tax Matters

36. Who prepares the tax returns? \_\_\_\_\_
37. Describe major differences between book and tax income, unusual tax elections, carry forwards or IRS examinations in process. If possible, review copies of the most recent 3 years of tax returns and attach them to this form. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

#### Other Matters

38. Describe any significant problems that could affect the engagement, such as litigation or other contingencies, unusual agreements, and plans to acquire or dispose of significant assets, merge with another entity, enter a new area of business, convert to or expand use of information technology, etc. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
39. Give the name of a current or former independent CPA. \_\_\_\_\_  
\_\_\_\_\_
- a. Describe any disputes over accounting matters. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
40. Describe any apparent problems or areas for improvement that were noted where our firm could provide additional service or recommendations. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
41. Is the client relatively free from controversy and media coverage? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

#### Independence

42. Would service to this client cause problems of independence or conflicts of interest because of relationships with other clients or members of the staff? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

#### Fees

43. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

44. If possible indicate the amount of fees charged by an existing or former independent CPA for the service being proposed. (The CPA or the potential client may be willing to furnish this information, or it might be obtainable from the financial statements or tax return.) \_\_\_\_\_
45. Describe any other indications that our firm might have a problem billing or collecting our fees. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
46. Does the prospective fee justify pursuing this engagement? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

### Management Integrity

47. Have any of the following sources raised any concerns about management's integrity?
- a. Difficulty in obtaining information from management, or evasive, guarded or glib responses to inquiries. \_\_\_\_\_  
\_\_\_\_\_
  - b. Apparent difficulty in meeting financial operations or a deteriorating financial position that might predispose management to commit fraud or make a 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. \_\_\_\_\_  
\_\_\_\_\_
48. If management is changing accountants, why is the change being made, and is the reason for the change acceptable? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
49. Is there any reason to suspect that management would be uncooperative, unreasonable or otherwise unpleasant to work with? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
50. Does the general integrity of the client seem satisfactory? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

### Other Comments or Observations

51. Give any other comments or observations that might affect our decision whether to prepare a proposal letter or its contents. Add attachments to this form, if necessary. \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

### Conclusion

52. Should we accept/continue this client/engagement? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

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Summary Control Checklist			
Firm Name _____ Quality Control Monitoring System Summary Year Ended _____			
Monitoring Procedure	Reviewed		Location of Documentation
	By	Date	
Analysis of the relevance of new professional pronouncements			
Continuing professional education and other professional development activities			
Independence confirmations			
Client/engagement acceptance and continuation decisions			
Interviews of firm personnel			
Review of engagements			
Inspection (describe procedures performed)			
Other procedures (describe)			
Determine that the above procedures have adequately considered and evaluated:			
1. The firm's management philosophy.			
2. Its practice environment.			
3. The relevance and adequacy of firm policies and procedures.			
4. Compliance with firm policies and procedures			
5. Appropriateness of the firm's guidance materials and practice aids.			
6. Effectiveness of professional development activities.			

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**.25 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.

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D. Development of Inspection Program:

1. Describe programs used and indicate any deviations therefrom.

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2. Describe basis for selection of engagements:

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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.

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## B. Engagements Reviewed:

	Firm Totals		Engs. Reviewed	
	Hrs.	No. of Engs.	Hrs.	No. of Engs.
Audits:				
SEC Clients				
Government <sup>1</sup>				
ERISA				
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.

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Supervisory Partner \_\_\_\_\_  
Date \_\_\_\_\_

<sup>1</sup> Includes only audits conducted pursuant to the *Government Auditing Standards*, issued by the Comptroller General of the United States ("yellow book").

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**Note:** A firm should make the analysis and assessment of the relevance of new professional pronouncements that can affect its practice, and consequently its quality control system, an ongoing activity. The AICPA's *Journal of Accountancy* publishes many of the new pronouncements in its Official Releases column. Thus, a practitioner can review the new pronouncements monthly (or after tax season for the first three months of the year) and record that review on a checklist similar to the one below.

New Pronouncements Checklist						
Firm Name _____						
Analysis of New Professional Pronouncements						
The purpose of this checklist is to document the firm's analysis and assessment of the relevance of new professional pronouncements to the firm practice.						
Professional Pronouncement	Effective Date	Reviewed		Relevant?		Comment, Reference
		By	Date	Yes	No	
<b>Auditing Standards:</b> Statement on Auditing Standards No. 85, <i>Management Representations</i>	Audits of financial statement for periods ending on or after 6/30/98					
<b>Attestation Standards</b>						
<b>Auditing Interpretations</b>						
<b>Attestation Interpretations</b>						
<b>Standards for Accounting and Review Services</b>						
<b>Other AICPA Official Releases</b> Statement of Position 98-5, <i>Reporting on the Costs of Start-Up Activities</i>	Year beginning after 12/15/98					
<b>Other Professional Pronouncements</b> Office of Management and Budget Circular A-133, <i>Audits of Institutions of Higher Education and Other Non-Profit Institutions</i>	Years ending on or after 6/30/97					

Professional Pronouncement	Effective Date	Reviewed		Relevant?		Comment, Reference
		By	Date	Yes	No	
<b>Financial Accounting Standards Board</b> Statement No. 132, <i>Employers' Disclosures about Pensions and Other Postretirement Benefits</i>	Years beginning after 12/15/97					
<b>Governmental Accounting Standards Board</b>						
<b>Other Pronouncements</b>						

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# AAM Section 12,000

## State and Local Governments

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## Section

## Paragraph

12,400	Auditors' Reports on Basic or General-Purpose Financial Statements for State and Local Governmental Units—continued	
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[The next page is 12,051.]

# AAM Section 12,010

## *Internal Control Form— Governmental Units*

.01 This section and AAM sections 12,200 and 12,300 contain illustrative internal control forms you might use to document your understanding of internal control sufficient to plan an audit of the general purpose financial statements of a state or local government.<sup>1</sup> 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 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.

.03 This form should be used in conjunction with other forms in the following circumstances:

- *Computer Applications Form—Governmental Units* [AAM section 12,020]. 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 Forms—Governmental Units* [AAM section 12,030]. To be used for each significant account and transactions cycle.

.04 These forms are appropriate whenever you plan a primarily substantive approach to the financial statement audit (see paragraph .06 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.<sup>2</sup>

.05 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.

The form at AAM Section 12,030 identifies the financial statement assertions to which those specific controls apply.

.06 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

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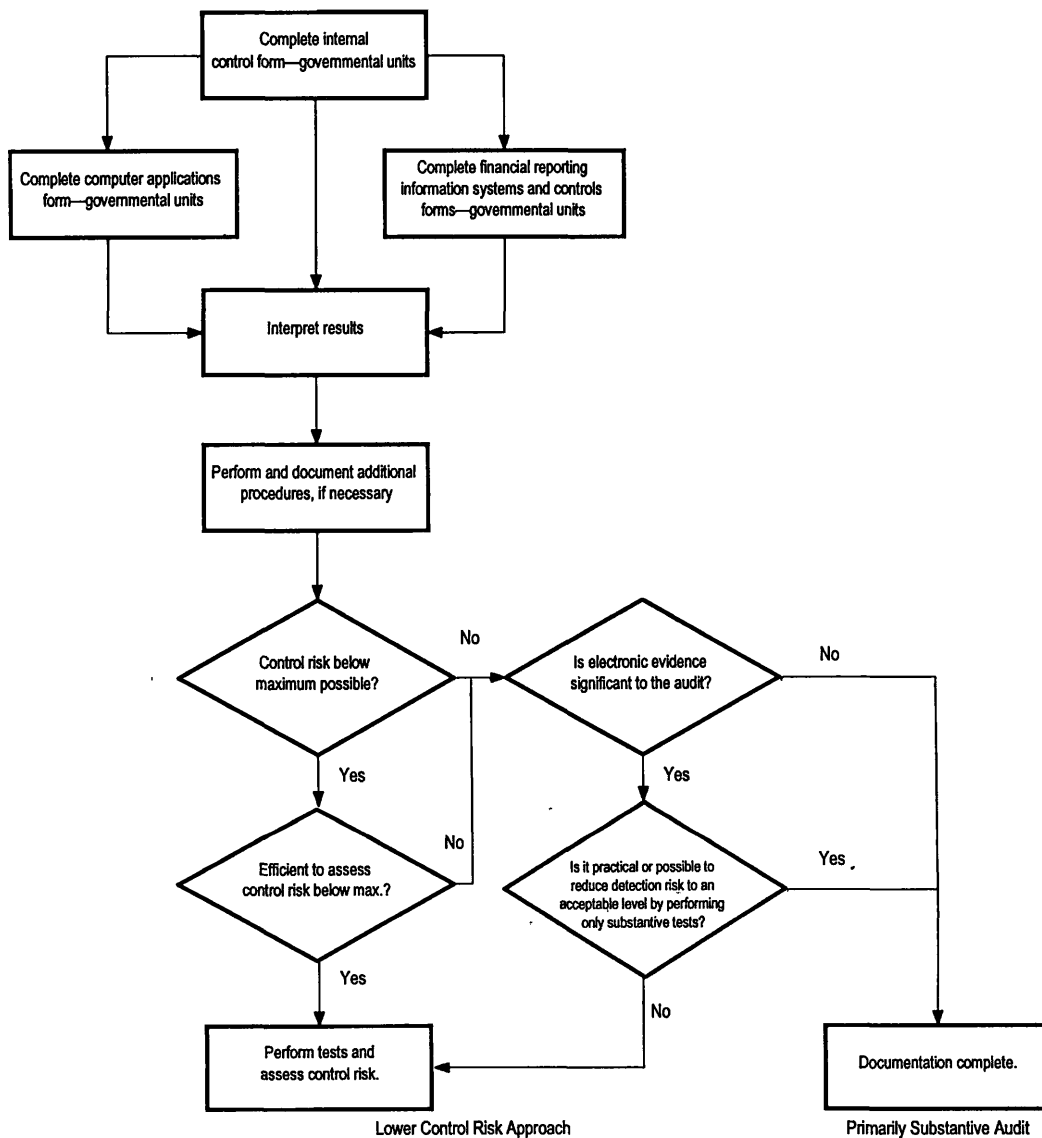
<sup>1</sup> See also AAM section 12,040, *Internal Control Checklist—Federal Awards* (OMB Circular A-133 Single Audits), which can be used to evaluate internal control over compliance requirements for major programs in an audit in accordance with Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

<sup>2</sup> As discussed at AAM section 12,040, OMB Circular A-133 requires the auditor to plan the testing of internal control over compliance with major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. Therefore, a substantive approach to the single audit is not permitted:

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 those 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. (See AU section 326, *Evidential Matter*.)

.07 These forms are organized to conform to the control components and overall internal control framework described in the Audit Guide *Consideration of Internal Control in a Financial Statement Audit*. This framework is a way for you to consider the impact of internal control on an audit. The classification of any specific control into a particular component should not be your primary concern. Rather, your primary consideration is whether a specific control affects financial statement assertions.

.08 The following flowchart describes how this form can be used in conjunction with the other forms to document your understanding of internal control.



## Interpreting the Results

.09 When obtaining an understanding of internal control, you should consider the *collective* effect of the strengths and weaknesses in various control components. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, strong management oversight may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by management to overstate earnings.

.10 Answers that fall toward the right side of this form ("Strongly Agree" or "Somewhat Agree") indicate areas of strength in the entity's internal control. You should consider whether these areas of strength indicate that a control risk assessment below the maximum may be possible for some assertions. Answers that fall toward the left side of this form ("Strongly Disagree" or "Somewhat Disagree") indicate areas of weakness in the entity's internal control. You should assess how these areas of weakness affect the planning of the audit. This assessment should be documented in section V of this 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

.11 After completing this form and the forms at AAM sections 12,020 and 12,030, you should document your conclusion regarding internal control. 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.

.12 If the completion of this form is not sufficient for you to obtain the necessary level of understanding discussed in paragraph .11 above, you should perform and document the results of additional procedures to gain that level of understanding.

.13

### 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 concerning internal control components with a pervasive effect on the entity. 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.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>A. Control Environment</b>					
<i>Integrity and Ethical Values</i>					
1. Management has high ethical and behavioral standards.	_____	_____	_____	_____	_____
2. The entity is not subject to external forces or pressures that make it vulnerable to errors.	_____	_____	_____	_____	_____
3. The public perceives this entity to be ethically managed and adequately controlled.	_____	_____	_____	_____	_____
4. Management has communicated (either formally through written policies or informally through its own behavior) the ethical and behavioral standards for the entity and employees have received and understood that message.	_____	_____	_____	_____	_____
5. Management reinforces its ethical and behavioral standards.	_____	_____	_____	_____	_____
6. Management appropriately deals with signs that problems exist even when the fiscal or political cost of identifying and solving the problem could be high.	_____	_____	_____	_____	_____
7. 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—					
a. Pressure to meet unrealistic performance targets.	_____	_____	_____	_____	_____
b. High performance-dependent rewards.	_____	_____	_____	_____	_____
c. Upper and lower cutoffs on bonus plans.	_____	_____	_____	_____	_____
8. Management has provided guidance on the situations and frequency with which intervention of established controls is appropriate.	_____	_____	_____	_____	_____
9. Management intervention is documented and explained appropriately.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b><i>Commitment to Competence</i></b>					
10. Management has appropriately considered the knowledge, experience, and skill levels necessary to accomplish management, financial reporting, and other essential tasks.	_____	_____	_____	_____	_____
11. Employees with management, financial reporting, and other essential responsibilities generally have the knowledge, experience, and skills necessary to accomplish those tasks.	_____	_____	_____	_____	_____
<b><i>Governing Board and Audit Committee</i></b>					
12. The governing board constructively challenges management's planned decisions.	_____	_____	_____	_____	_____
13. Members of the governing board have sufficient knowledge, experience, and time to serve effectively.	_____	_____	_____	_____	_____
14. The board members regularly receive 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—					
a. Reasonableness of the financial reporting process.	_____	_____	_____	_____	_____
b. System of internal control.	_____	_____	_____	_____	_____
c. Significant comments and recommendations.	_____	_____	_____	_____	_____
d. 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.	_____	_____	_____	_____	_____
<b><i>Management's Philosophy and Operating Style</i></b>					
19. Management moves carefully, proceeding only after carefully analyzing the risks and potential benefits of its actions	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
20. Management is generally cautious or conservative in financial reporting matters (such as the selection of accounting policies; application of accounting principles, the development of estimates, and the disclosure of important financial information).	_____	_____	_____	_____	_____
21. There is relatively low turnover of key personnel (such as operating, accounting, data processing, and internal audit).	_____	_____	_____	_____	_____
22. There is no undue pressure to meet budget 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. Management is concerned about the presence of strong data processing controls.	_____	_____	_____	_____	_____
25. Management is committed to reliable financial reporting and the safeguarding of assets.	_____	_____	_____	_____	_____
26. Operating personnel review and "sign off" on reported results.	_____	_____	_____	_____	_____
27. There is frequent interaction between senior management and operating management, particularly for geographically removed units.	_____	_____	_____	_____	_____
28. There is a long-range planning process.	_____	_____	_____	_____	_____
29. Goals and objectives for the entity are current and in writing.	_____	_____	_____	_____	_____
<b>Organizational Structure</b>					
30. The entity's organization chart is current.	_____	_____	_____	_____	_____
31. The entity's organizational structure facilitates the appropriate flow of information relating to its activities.	_____	_____	_____	_____	_____
32. Organizational relationships are appropriate.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
33. Organizational modifications are made when needed due to changing conditions.	_____	_____	_____	_____	_____
34. There are sufficient quantities of employees, particularly in management and supervisory capacities.	_____	_____	_____	_____	_____
35. The organizational structure is appropriate given the entity's program/budget structure.	_____	_____	_____	_____	_____
<b><i>Assignment of Authority and Responsibility</i></b>					
36. Written job descriptions are current.	_____	_____	_____	_____	_____
37. Personnel have copies of their own job descriptions and those of their subordinates.	_____	_____	_____	_____	_____
38. Job descriptions are consistent with the organization chart.	_____	_____	_____	_____	_____
39. Delegations of authority and responsibility reflect the segregation of duties concept.	_____	_____	_____	_____	_____
40. Job descriptions are descriptive of the jobs actually performed.	_____	_____	_____	_____	_____
41. Job descriptions contain specific references to control-related responsibilities.	_____	_____	_____	_____	_____
42. Members of management fully understand their control responsibilities.	_____	_____	_____	_____	_____
43. The entity's principal accounting officer has adequate authority over accounting employees and principal accounting records locations.	_____	_____	_____	_____	_____
44. Delegations of authority and responsibility give personnel necessary authority to carry out the functions for which they are responsible.	_____	_____	_____	_____	_____
45. There is an adequate definition of key managers' responsibilities and an appropriate understanding of those responsibilities.	_____	_____	_____	_____	_____
46. Financial reporting responsibilities are clearly defined and reasonably aligned.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
47. Personnel are given proper resources to carry out their duties.	_____	_____	_____	_____	_____
48. Personnel are held accountable for performance and results achieved.	_____	_____	_____	_____	_____
49. Managers routinely follow-up on delegations of authority and responsibility to subordinates.	_____	_____	_____	_____	_____
50. Personnel understand the entity's objectives and know how their individual actions interrelate and contribute to those objectives.	_____	_____	_____	_____	_____
<b><i>Human Resource Policies and Practices</i></b>					
51. There are written personnel policies, including for hiring, training, promoting, and compensating employees.	_____	_____	_____	_____	_____
52. Payroll and personnel policies governing compensation are in accordance with the requirements of grant agreements.	_____	_____	_____	_____	_____
53. The entity generally hires the most qualified people for the job.	_____	_____	_____	_____	_____
54. Hiring and recruiting practices emphasize educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior (including background checks for prior actions or activities considered to be unacceptable by the entity).	_____	_____	_____	_____	_____
55. Recruiting practices include formal, in-depth employment interviews.	_____	_____	_____	_____	_____
56. Policies regarding conflicts of interest and code of conduct are established, documented, and distributed.	_____	_____	_____	_____	_____
57. New employees receive orientation training, which includes information about the entity's history, culture, and operating style.	_____	_____	_____	_____	_____
58. There are accurate and up-to-date performance standards.	_____	_____	_____	_____	_____
59. The entity's performance standards are consistent with its operating plan.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
60. Management performance standards include provisions for maintaining adequate internal control.	_____	_____	_____	_____	_____
61. Employees are made aware of their responsibilities and expectations of them.	_____	_____	_____	_____	_____
62. The entity provides training opportunities, and employees are well-trained.	_____	_____	_____	_____	_____
63. There are adequate employee retention and promotion criteria, and related information gathering techniques, related to compliance with the code of conduct or other behavioral guidelines.	_____	_____	_____	_____	_____
64. There are periodic performance appraisals of all employees.	_____	_____	_____	_____	_____
65. Promotions and rotation of personnel are based on periodic performance appraisals.	_____	_____	_____	_____	_____
66. Methods of compensation, including bonuses, are designed to motivate personnel and reinforce outstanding performance.	_____	_____	_____	_____	_____
67. Appropriate remedial action is taken in response to departures from approved controls and violations of the code of conduct.	_____	_____	_____	_____	_____
68. Employees are adequately supervised.	_____	_____	_____	_____	_____
69. Staffing levels are adequate.	_____	_____	_____	_____	_____
70. Turnover is low.	_____	_____	_____	_____	_____
71. Employees have the right to communicate with any official of rank higher than their immediate supervisor.	_____	_____	_____	_____	_____
<b>B. Risk Assessment</b>					
1. Management has a process to identify and analyze risks relating to circumstances such as new laws or regulations that affect the entity and new or redesigned services or activities.	_____	_____	_____	_____	_____
2. Special action is taken to ensure new personnel understand their tasks.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
3. Management appropriately considers the control activities performed by personnel who change jobs or leave the entity.	_____	_____	_____	_____	_____
4. Management evaluates the risks relevant to the preparation of financial statements and management takes appropriate steps to manage those risks.	_____	_____	_____	_____	_____
5. Management assesses how new accounting and information systems will impact entity risks and internal control.	_____	_____	_____	_____	_____
6. There are mechanisms to identify and react to changes as a result of new technology integrated into the information system.	_____	_____	_____	_____	_____
7. Employees are adequately trained when accounting and information systems are changed or replaced.	_____	_____	_____	_____	_____
8. Accounting and information system capabilities are upgraded when the volume of information increases significantly.	_____	_____	_____	_____	_____
9. Accounting and data processing personnel are expanded as needed when the volume of information increases significantly.	_____	_____	_____	_____	_____
10. Controls exist for approving decisions regarding financing alternatives and accounting principles, practices, and methods.	_____	_____	_____	_____	_____
11. The entity has the ability to reasonably forecast operating and financial results.	_____	_____	_____	_____	_____
<b>C. General Control Activities</b>					
1. The entity prepares operating and capital budgets and cash flow projections.	_____	_____	_____	_____	_____
2. Budgets and projections lend themselves to effective comparison with actual results.	_____	_____	_____	_____	_____
3. Significant variances between budgeted or projected amounts and actual results are reviewed and explained.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
4. The entity has adequate written statements and explanations of its accounting controls, including—					
a. A chart of accounts accompanied by explanations of the items to be included in 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 nonrecurring entries.	_____	_____	_____	_____	_____
d. Explanations of documentation and approval requirements for various types of recurring and nonrecurring 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.	_____	_____	_____	_____	_____
5. Internal control manuals are updated as necessary.	_____	_____	_____	_____	_____
6. Internal control manuals are distributed to appropriate personnel.	_____	_____	_____	_____	_____
7. There are written procedures to test and implement new systems and modifications to existing systems.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
8. There is general ledger control over all assets and transactions of all departments of the entity.	_____	_____	_____	_____	_____
9. All journal entries are reviewed and supported by adequate descriptions or documentation.	_____	_____	_____	_____	_____
10. Controls exist that ensure that only authorized individuals can initiate entries into the accounting system.	_____	_____	_____	_____	_____
11. Procedures exist to ensure the orderly and effective accumulation of financial data, including that received from departments and other accounting units.	_____	_____	_____	_____	_____
12. Valuation reserves or other account balances based on estimates are reviewed and approved.	_____	_____	_____	_____	_____
13. The flow of expenditures or commitments is controlled through the use of an allotment system.	_____	_____	_____	_____	_____
14. Measures are implemented to correct internal control weaknesses.	_____	_____	_____	_____	_____
15. Appropriate insurance coverage is maintained in amounts required by statutes or entity policy. (Such insurance may include coverage for loss of records and assets as well as fidelity bonding of employees in positions of trust.)	_____	_____	_____	_____	_____
16. The entity has adequate safekeeping facilities for custody of the accounting records such as fire-resistant locked cabinets, vaults, physical barriers, separate rooms, limited access to work areas, alarms, and other detection devices.	_____	_____	_____	_____	_____
17. The entity has a suitable record retention plan.	_____	_____	_____	_____	_____
18. There is adequate segregation of duties among those responsible for authorizing transactions, recording transactions, and maintaining custody of assets.	_____	_____	_____	_____	_____
19. Access to the general ledger and related records is restricted to those who are assigned general ledger responsibilities.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>D. Information and Communication</b>					
1. Management receives the information they need to carry out their responsibilities.	_____	_____	_____	_____	_____
2. Information is provided at the right level of detail for different levels of management.	_____	_____	_____	_____	_____
3. Plans and budgets are effectively communicated throughout the entity.	_____	_____	_____	_____	_____
4. Information is available on a timely basis.	_____	_____	_____	_____	_____
5. Accounting and financial reporting policies and procedures are current, in writing, consistent with statutory authority, and support internal control.	_____	_____	_____	_____	_____
6. All journal entries are adequately explained and supported.	_____	_____	_____	_____	_____
7. All journal entries are subject to controls over completeness of processing (such as 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).	_____	_____	_____	_____	_____
8. All journal entries include adequate identification of the accounts in which they are to be recorded.	_____	_____	_____	_____	_____
9. Controls for closing the accounts for a reporting period are sufficient to ensure that accounts are closed, adjusted, and reviewed on a timely basis.	_____	_____	_____	_____	_____
10. Procedures exist to ensure that the financial reporting information system has included all transactions applicable to the reporting period.	_____	_____	_____	_____	_____
11. Procedures exist to ensure that financial reports are supported by either underlying account records or other documentation.	_____	_____	_____	_____	_____
12. Procedures exist providing reasonable assurances that all data required to be included in reports are properly disclosed.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
13. Procedures exist to permit the recording and review of special entries generated in the process of developing financial statements.	_____	_____	_____	_____	_____
14. Reporting controls exist for in-progress and completed construction projects.	_____	_____	_____	_____	_____
15. Procedures exist to ensure that financial reports are prepared on a consistent basis.	_____	_____	_____	_____	_____
16. Performance and financial reports are reviewed and approved at appropriate levels of management and, if appropriate, by the governing board before public release.	_____	_____	_____	_____	_____
17. There are procedures to ensure that all requirements for filing of financial reports are met.	_____	_____	_____	_____	_____
18. There are channels of communication for people to report suspected improprieties (for example, an ability to contact someone other than a direct supervisor with anonymity permitted).	_____	_____	_____	_____	_____
19. Feedback is provided to personnel who report suspected improprieties and they have immunity from reprisals.	_____	_____	_____	_____	_____
20. Management is receptive to reports of suspected improprieties.	_____	_____	_____	_____	_____

**E. Monitoring**

1. There is timely and appropriate follow-up action by management resulting from external party communications, such as customer complaints, notification of errors in billings, and notification of inappropriate behavior by an employee.	_____	_____	_____	_____	_____
2. Communications from bankers, regulators, or other outside parties are monitored for items of accounting significance.	_____	_____	_____	_____	_____
3. Program evaluations and management reviews are routinely performed.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
4. Employees are required to "sign off" to evidence the performance of critical control functions.	_____	_____	_____	_____	_____
5. Management periodically reviews internal control to ensure that it is appropriate and being enforced.	_____	_____	_____	_____	_____
6. Accounting managers and personnel are supervised at all locations.	_____	_____	_____	_____	_____
7. Audits are routinely performed.	_____	_____	_____	_____	_____
8. The internal auditors are independent of the activities they audit.	_____	_____	_____	_____	_____
9. Internal auditors have adequate training and experience.	_____	_____	_____	_____	_____
10. Internal auditors document the planning and execution of their work by such means as audit programs and working papers.	_____	_____	_____	_____	_____
11. Internal audit reports are submitted to the governing board or audit committee.	_____	_____	_____	_____	_____
12. Management responds appropriately to auditor recommendations on ways to strengthen internal control.	_____	_____	_____	_____	_____
13. Procedures exist requiring prompt implementation of recommendations from audit findings, program evaluations, and management reviews.	_____	_____	_____	_____	_____

## II. Determine Other Areas For Evaluation

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. Because 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. An auditor also should obtain an understanding of internal control over significant account balances and transactions. In the space provided below, determine which of the following areas apply. A "Yes" answer generally indicates you should complete the related form.

	<u>No</u>	<u>Yes</u>	<u>W/P References</u>
<b>Computers or Outside Service Bureaus</b>			
1. The entity uses computers or outside computer service bureaus to process significant accounting information (see form at AAM section 12,030).	_____	_____	_____

	<i>No</i>	<i>Yes</i>	<i>W/P References</i>
<b>Significant Account Balances and Transaction Cycles</b>			
1. The following account balances or transaction cycles are significant to the entity's financial statements.			
a. Budgetary process (see form at AAM section 12,030.01).	_____	_____	_____
b. Revenue cycle, including revenue, accounts receivable, and cash receipts (see form at AAM section 12,030.13). (Normally considered significant for governmental entities.)	_____	_____	_____
c. Purchasing cycle, including expenditures/expenses, payables, and cash disbursements (see form at AAM section 12,030.25). (Normally considered significant for governmental entities.)	_____	_____	_____
d. Cash and investments (see form at AAM section 12,030.37).	_____	_____	_____
e. Fixed assets (see form at AAM section 12,030.49).	_____	_____	_____
f. Payroll cycle (see form at AAM section 12,030.61). (Normally considered significant for governmental entities.)	_____	_____	_____
g. Others (list): _____	_____	_____	_____
_____	_____	_____	_____

### III. Assess Segregation of Duties

An appropriate segregation of duties often appears to present difficulties in small governmental entities or accounting offices with only a few personnel. However, even smaller entities can usually divide 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 management or the governing board can provide the necessary control. For example, it is not uncommon, where there is a risk of improper cash payments in a small entity, for the governing board to periodically review a listing of all checks written. In the space provided below, assess risk due to a lack of segregation of duties for the entity, 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.

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#### 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 or reduce reported deficits, to meet budgeted revenues or expenditures/expenses, 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. An active, involved governing board 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 entity. 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.

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#### 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.

<u>Accounts, Transactions, and Assertions</u>	<u>Test of Controls Working Paper Reference</u>
<hr/>	<hr/>
<hr/>	<hr/>
<hr/>	<hr/>
<hr/>	<hr/>

- 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.

[illegible]

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	<i>Unmodified Commercial</i>	<i>In-House</i>	<i>N/A</i>
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.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>Acquisition of Hardware</b>					
1. The entity has a coherent management plan for the purchase of and continued investment in computer hardware.	_____	_____	_____	_____	_____
2. The computer hardware is sufficient to meet the entity's needs.	_____	_____	_____	_____	_____
3. The entity's computer hardware is safely and properly installed.	_____	_____	_____	_____	_____
4. The entity has standard, regular hardware maintenance procedures.	_____	_____	_____	_____	_____
<b>Acquisition of Software</b>					
5. The entity has a coherent management plan for the purchase of and continued investment in computer software.	_____	_____	_____	_____	_____
6. The entity researches software products to determine whether they meet the needs of the intended users.	_____	_____	_____	_____	_____
7. The entity's application programs are compatible with each other.	_____	_____	_____	_____	_____
8. The entity obtains recognized software from reputable sources.	_____	_____	_____	_____	_____
9. Entity policy prohibits the use of unauthorized programs introduced by employees.	_____	_____	_____	_____	_____
10. Entity policy prohibits the downloading of untested software from sources such as dial-up bulletin boards.	_____	_____	_____	_____	_____
11. The entity uses virus protection software to screen for virus infections.	_____	_____	_____	_____	_____
<b>Program Development</b>					
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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
16. Adequate procedures exist to transfer programs from development to production libraries.	_____	_____	_____	_____	_____
<b>Program Changes</b>					
17. Users are involved in the design and approval of program changes.	_____	_____	_____	_____	_____
18. Program changes are thoroughly tested.	_____	_____	_____	_____	_____
19. Users are involved in the review of tests of program changes.	_____	_____	_____	_____	_____
20. Adequate procedures exist to transfer changed programs from development to production libraries.	_____	_____	_____	_____	_____
<b>Logical Access</b>					
21. The entity has controls to limit access to computer hardware, software, and documentation to authorized employees.	_____	_____	_____	_____	_____
22. Management has identified confidential and sensitive data for which access should be restricted.	_____	_____	_____	_____	_____
23. Procedures are in place to restrict access to confidential and sensitive data.	_____	_____	_____	_____	_____
24. Procedures are in place to reduce the risk of unauthorized transactions being entered into processing.	_____	_____	_____	_____	_____
25. The use of utility programs is controlled or monitored carefully.	_____	_____	_____	_____	_____
26. Procedures are in place to detect unauthorized changes to programs supporting the financial statements.	_____	_____	_____	_____	_____
27. Programmer access to production programs, live data files, and job control language is controlled.	_____	_____	_____	_____	_____
28. Operator access to source code and individual elements of data files is controlled.	_____	_____	_____	_____	_____
29. Users have access only to defined programs and data files.	_____	_____	_____	_____	_____
<b>Physical Security</b>					
30. Procedures exist to protect against loss of important files, programs, and equipment.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
31. The entity has established procedures for the periodic back-up of files.	_____	_____	_____	_____	_____
32. Back-up procedures include multiple generations.	_____	_____	_____	_____	_____
33. Back-up files are stored in a secure, off-site location.	_____	_____	_____	_____	_____
34. Equipment, programs, and data files are covered by insurance.	_____	_____	_____	_____	_____
<b>Data Processing Operations</b>					
35. Procedures to be followed by computer operators are documented.	_____	_____	_____	_____	_____
36. A job accounting system (or console logs) is used to ensure that scheduled programs are processed and proper procedures are followed.	_____	_____	_____	_____	_____
37. Operations management reviews lists of regular and unscheduled batch jobs.	_____	_____	_____	_____	_____
38. Job control instruction sets are menu-driven.	_____	_____	_____	_____	_____
39. Jobs are executed only from the operator's terminal.	_____	_____	_____	_____	_____
40. Controls exist over the preparation and approval of input transactions outside the data processing department and the department is prohibited from initiating transactions.	_____	_____	_____	_____	_____
41. The user departments exercise control procedures over input to ensure that all approved input is processed correctly through the system and only once.	_____	_____	_____	_____	_____
42. Appropriate data entry and program controls exist (for example, to edit and validate input data, to prevent documents from being keyed into the system more than once, to permit tracing from computer output to data source and vice versa, and to balance transaction and master files).	_____	_____	_____	_____	_____
43. 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 verification against a printout of changes.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
44. The data processing and user departments have controls over rejected transactions.	_____	_____	_____	_____	_____
45. Procedures exist to properly control data between the user and the data processing departments.	_____	_____	_____	_____	_____
46. Controls exist relating to the review and distribution of output.	_____	_____	_____	_____	_____
47. Computer operators are supervised on all shifts.	_____	_____	_____	_____	_____
48. Clear job descriptions exist for data processing personnel.	_____	_____	_____	_____	_____
49. There is adequate program and system documentation.	_____	_____	_____	_____	_____

**Segregation of Duties**

50. The data processing department is independent of the accounting and operating departments for which it processes data.	_____	_____	_____	_____	_____
51. Appropriate segregation of duties exist within the data processing function for					
a. Systems development (design and programming).	_____	_____	_____	_____	_____
b. Technical support (maintenance of system software).	_____	_____	_____	_____	_____
c. Operations.	_____	_____	_____	_____	_____
52. In smaller and minicomputer installations with limited opportunities for segregation of duties, procedures exist for user departments to—					
a. Use batch or other input controls	_____	_____	_____	_____	_____
b. Control master file changes	_____	_____	_____	_____	_____
c. Balance master files between processing cycles.	_____	_____	_____	_____	_____
53. The personnel policies of the data processing function includes such procedures as reference checks, security statements, rotation of duties, and terminated employee security measures that enhance segregation of duties and otherwise improve controls.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>Training</b>					
54. Management periodically assess the training needs of computer operators and personnel who use microcomputers to process significant accounting information.	_____	_____	_____	_____	_____
55. Computer operators and personnel who use microcomputers to process significant accounting information are adequately trained.	_____	_____	_____	_____	_____

#### IV. Outside Computer Service Organizations

This section should be used to document your understanding of how the entity 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*, as amended (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.

\_\_\_\_\_  
\_\_\_\_\_

Prepared or updated by:	19__	19__	20__	20__
Reviewed by:	_____	_____	_____	_____

\_\_\_\_\_

[The next page is 12,100-31.]



## AAM Section 12,030

# *Financial Reporting Information Systems and Controls Forms—Governmental Units*

### Budgetary Process

.01 This form may be used on any audit engagement of a governmental entity when the budgetary process is significant.

.02 The purpose of this form is to document your understanding of controls for significant classes of transactions. Your knowledge of the budgetary process should be sufficient for you to understand—

- How the budget is developed and adopted.
- How the approved budget and budgetary amendments are incorporated into the accounting system and financial statements.
- How the entity ensures its budgetary process complies with laws and regulations.

### Interpreting Results

.03 This form documents your understanding of how internal control over the budgetary process is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. In entities where a significant amount of 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). Because 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 financial statement 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. If you plan a lower control risk assessment for certain assertions relating to the budgetary process, the following checklist uses the following coding to identify parenthetically after the control the financial statement assertions to which that control applies:

E = Existence or occurrence

C = Completeness

R = Rights and obligations

V = Valuation or allocation

P = Presentation and disclosure

.04 The processes, documents, and controls listed on this questionnaire are typical for governmental 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 entity’s system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.05

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Budget Preparation</b>				
1. Responsibilities for budget preparation, adoption, execution, and reporting are segregated. (E, C, R, V, P)	_____	_____	_____	_____
2. Budgets are prepared for all significant activities regardless of whether mandated by law. (E, C)	_____	_____	_____	_____
3. The budgeting system is integrated with the planning process.	_____	_____	_____	_____
4. The budget is prepared in sufficient detail to provide a meaningful tool with which to monitor subsequent performance. (E, C, P)	_____	_____	_____	_____
5. The type of budgeting performed is compatible with the accounting system. (E, C, P)	_____	_____	_____	_____
6. Interfund and interdepartmental transfers are included in the budget. (E, C, R, P)	_____	_____	_____	_____
7. Procedures have been adopted and communicated to establish authority and responsibility for transfers between budget categories. (E, C, R, P)	_____	_____	_____	_____
<b>II. Budget Approval</b>				
8. Controls exist to ensure that the original budget and any budgetary amendments (including supplemental appropriations and, if required, budget transfers) are submitted to the governing body for approval. (E, C, R, V, P)	_____	_____	_____	_____
9. A budget calendar is used for the orderly submission and approval of the budget. (E, C)	_____	_____	_____	_____
10. Proposed budgets are published and subject to public hearings, if required by law. (E, P)	_____	_____	_____	_____
11. There is a process to clearly communicate to operating departments and agencies the effects of legislatively mandated budget amendments. (E)	_____	_____	_____	_____
<b>III. Budget Accounting and Reporting</b>				
12. Estimated revenues and appropriations are recorded in the accounting records for later comparison to actual amounts realized or incurred. (E, C, R, V, P)	_____	_____	_____	_____
13. Actual expenditures are compared to the budget on a timely basis with reasonable (monthly) frequency. (C, V, P)	_____	_____	_____	_____
14. Reports are discussed with departmental personnel and there are explanations for significant variations from the budget. (E, C, R, V, P)	_____	_____	_____	_____
15. Top management and the governing body are notified of expenditures in excess of appropriations or budgets. (E, R, V, P)	_____	_____	_____	_____
16. Actual results of operations against the budget are published if required by law. (E, C, R, V, P)	_____	_____	_____	_____



**Budgetary Processes**

- |   | <u>Personnel</u> | <u>N/A</u> | <u>No</u> | <u>Yes</u> |
|---|------------------|------------|-----------|------------|
| 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 Computer Applications Form—Governmental Units (AAM section 12,020) was used to document your understanding of the entity'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 budgetary process.

.12 In the space below, describe the budgetary process information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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19\_\_

19\_\_

20\_\_

20\_\_

Prepared or updated by:

Reviewed by:

_____	_____	_____	_____
_____	_____	_____	_____



## Revenue Cycle—Revenue, Accounts Receivable, and Cash Receipts

**.13** This form may be used on any audit engagement of a governmental entity when the revenue cycle is significant. The revenue cycle is usually significant in governmental audit engagements.

**.14** The purpose of this form 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 revenues are assessed and levied.
- How cash receipts are recorded.
- How revenues and cash receipts are processed by the accounting system.
- The accounting records and supporting documents involved in processing and reporting revenues, accounts receivable, and cash receipts.
- The processes used to prepare significant accounting estimates and disclosures.

## Interpreting Results

**.15** This form 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 a significant amount of 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). Because 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 financial statement 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. If you plan a lower control risk assessment for certain assertions relating to the revenue cycle, the following checklist uses the following coding to identify parenthetically after the control the financial statement assertions to which that control applies:

E = Existence or occurrence

C = Completeness

R = Rights and obligations

V = Valuation or allocation

P = Presentation and disclosure

**.16** The processes, documents, and controls listed on this questionnaire are typical for governmental 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 entity’s system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.17

**I. Revenue and Accounts Receivable****A. General**

1. Tax, fee, and service rates are authorized and periodically reviewed by the governing board. (E, R, V)
2. Procedures exist for the timely billing of amounts due. (E, C, R, V)
3. Updated records are used as the basis for billing persons subject to payment. (E, C, R, V)
4. Procedures exist to providing reasonable assurance that interest and penalties are properly charged on delinquent receivables. (E, C, R, V)
5. Procedures exist to timely notify the accounting department when billings are prepared and mailed. (E, C, R, V)
6. Procedures exist to prevent the interception or alteration by unauthorized persons of billings or statements after preparation but before mailing. (E, C, R, V)
7. An individual independent of receivables record keeping promptly investigate disputes with billing amounts that are reported by taxpayers or service recipients. (E, C, R, V)
8. Delinquent accounts are reviewed and considered for charge-off on a timely basis. (E, R, V)
9. Write-offs or other reductions of receivables are formally approved by senior personnel not involved in the collection function. (E, R, V)
10. Procedures exist to use all legal remedies to collect delinquent, charged-off, or uncollectible accounts. (E, C, R, V)
11. Aged accounts receivable balances are periodically reviewed by supervisory personnel. (E, C, R, V)
12. Controls exist that provide assurance that individual receivable records are posted only from authorized source documents. (E, C, R, V)
13. Aggregate collections on accounts receivable are reconciled against postings to individual receivable accounts. (E, R, V)
14. Trial balances of individual receivable accounts are prepared on a timely basis. (R, V)
15. Trial balances are reconciled with general ledger control accounts and reconciling items are investigated by someone other than accounts receivable clerks. (E, C, R, V)
16. The responsibility of billing revenues is segregated from collection and accounting. (E, C, R, V)
17. The responsibility for maintaining detail accounts receivable records is segregated from collections and general ledger posting. (E, C, R, V)

<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
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_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
18. Current year revenues are compared to prior-year revenues and current-year estimates and senior officials review explanations of variations. (E, C, R, V)	_____	_____	_____	_____
19. Revenues collected for the entity by another government (or other collection agent) are monitored to assure timely receipt, and the amounts received are reviewed for reasonableness. (E, C, R, V)	_____	_____	_____	_____
20. Amounts collected by the entity for other governments are segregated and remitted on a timely basis. (E, C, R, V)	_____	_____	_____	_____
<b>B. Taxes</b>				
21. Controls exist to ensure that all taxable property is assessed and billed. (E, C, R, V)	_____	_____	_____	_____
22. Controls exist to ensure that additions, deletions, transfers, and abatements are properly and timely reflected in property tax records. (E, C, R, V)	_____	_____	_____	_____
23. Procedures exist to make property assessments in accordance with the law or legislative intent with prompt adjustment of records. (E, C, R, V)	_____	_____	_____	_____
24. Controls exist to ensure that tax bills are accurate and that special charges are considered in preparing tax bills. (E, C, R, V)	_____	_____	_____	_____
25. Property tax assessment rolls are maintained by personnel not engaged in any accounting or collection function. (E, C, R, V)	_____	_____	_____	_____
26. Procedures exist providing for the timely filing of liens on property for nonpayment in all cases permitted by law. (C, R)	_____	_____	_____	_____
27. Self-assessed tax returns are cross-referenced against a database of previous taxpayers. (C)	_____	_____	_____	_____
28. Self-assessed tax returns are reviewed for mathematical accuracy. (E, C, R, V)	_____	_____	_____	_____
29. Self-assessed tax refund claims are reviewed and approved. (E, C, R, V)	_____	_____	_____	_____
30. Self-assessed tax returns are audited to provide reasonable assurance that taxable transactions are properly reported. (E, C, R, V)	_____	_____	_____	_____
31. Records are organized and integrated in such a fashion that probable taxpayers are identified as a result of reporting of other governmental activities, such as licensing. (C)	_____	_____	_____	_____
32. Controls exist to ensure that tax exemptions are within the law and properly approved. (E, C, R, V)	_____	_____	_____	_____
33. Tax exemption and relief programs are periodically reviewed and approved by the governing board. (C, R, V)	_____	_____	_____	_____
<b>C. Usage Fees and Service Charges</b>				
34. Controls ensure that the customer database and usage records are accurately maintained so that all amounts due are billed. (E, C, R, V)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
35. If billing is based on usage, service readings are performed in a timely fashion. (E, C, R)	_____	_____	_____	_____
36. Assignments of meter readers are periodically rotated. (E, C, R)	_____	_____	_____	_____
37. Procedures exist to identify and investigate unusual patterns of use. (E, C)	_____	_____	_____	_____
38. There are controls for extending credit to customers, such as a written policy and supervisory review of such situations. (R, V)	_____	_____	_____	_____

**D. Fines and Nonexchange Fees**

39. Records of payments due are maintained and used as a basis for collections. (E, C, R, V)	_____	_____	_____	_____
40. Controls exist surrounding the issuance and disposition of traffic violations to ensure that amounts due are assessed and collected. (E, C, R, V)	_____	_____	_____	_____
41. Procedures exist correlate amounts collected with records of court proceedings. (E, C, R, V)	_____	_____	_____	_____
42. Tickets for fines, arrests, and so forth are sequentially numbered and satisfactorily accounted for. (E, C)	_____	_____	_____	_____
43. Licenses are sequentially numbered and satisfactorily accounted for. (E, C)	_____	_____	_____	_____
44. If annual payments are involved, procedures exist to ensure that previous years' records are properly updated for new registrants and withdrawals. (E, C, R)	_____	_____	_____	_____

**II. Cash Receipts**

1. A restrictive endorsement is placed on each incoming check upon receipt. (C)	_____	_____	_____	_____
2. Facilities exist for protecting undeposited cash receipts. (C)	_____	_____	_____	_____
3. Receipts are accounted for and balanced to reported collections on a daily basis. (E, C, V)	_____	_____	_____	_____
4. Receipts are deposited intact and on a timely basis (preferably daily). (C)	_____	_____	_____	_____
5. Cash receipts are deposited in separate bank accounts when required. (E, C, R)	_____	_____	_____	_____
6. Reported collections are compared on a test basis to bank statements to verify that deposits are accurate and timely. (E, C, R, V)	_____	_____	_____	_____
7. Personnel who handle cash receipts are adequately bonded. (E, C, R)	_____	_____	_____	_____
8. Local office accounts used for branch office collections are subject to withdrawal only by the home office. (C)	_____	_____	_____	_____
9. Procedures exist that provide for timely and direct notification of the accounting department of collection activities. (E, C, R, V)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
10. If payments are made in person, receipts for payment are used and accounted for and balanced to collections. (E, C, R, V)	_____	_____	_____	_____
11. If checks received are forwarded to be used as posting media to taxpayers' or customers' accounts, controls exist to ensure that checks are returned promptly for deposit. (C)	_____	_____	_____	_____
12. "Not sufficient funds" checks are delivered to someone independent of processing and recording of cash receipts. (E, C, R, V)	_____	_____	_____	_____
13. Procedures exist for followup of "not sufficient funds" checks. (E, C, R, V)	_____	_____	_____	_____
14. Timely bank reconciliations are prepared and reviewed by someone independent of the cash receipts function. (E, C, R, V)	_____	_____	_____	_____
15. Controls exist over the collection, timely deposit, and recording of collections in the accounting records in each collection location. (E, C, R, V)	_____	_____	_____	_____
16. The responsibility for collecting, controlling, and depositing funds is segregated from maintaining accounting records. (E, C, R, V)	_____	_____	_____	_____
17. Responsibilities for cash receipts are segregated from those for cash disbursements. (E, C, R)	_____	_____	_____	_____

## End User Computing in the Revenue Cycle

**.18** End user computing occurs when the user is responsible for developing and executing a computer application that generates the information used by that same person. For example, an accounting clerk updates a database that calculates early payment discounts to taxpayers, and that calculation is the source of a journal entry.

**.19** *Computer Applications Form—Governmental Units* [AAM section 12,020] was used to document your understanding of computer applications operated by the entity's data processing department. In this section of the Financial Reporting Information Systems and Controls Form, you may document your understanding of how end user computing is used in the revenue cycle to process significant accounting information outside of the data processing 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 data processing department—operated accounting application. For example, a spreadsheet accumulates invoices to customers for batch processing.
- Make significant accounting decisions. For example, a spreadsheet ages accounts receivable and helps in determining write-offs.
- Accumulate footnote information. For example, a database of property tax levies and collections provides information for note disclosure.



**.24** In the space below, describe the revenue cycle information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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Prepared or updated by:

Reviewed by:

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## **Purchasing Cycle—Expenditures/Expenses, Payables, and Cash Disbursements**

**.25** This form may be used on any audit engagement of a governmental entity when the purchasing cycle is significant. The purchasing cycle is usually significant in governmental audit engagements.

**.26** The purpose of this form 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 are 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 processing and reporting purchases, accounts payable, and cash disbursements.
- How the entity controls compliance with grant requirements.
- The processes used to prepare significant accounting estimates and disclosures.

## **Interpreting Results**

**.27** This form 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 a significant amount of 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). Because 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 financial statement 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. If you plan a lower control risk assessment for certain assertions relating to the purchasing cycle, the following checklist uses the following coding to identify parenthetically after the control the financial statement assertions to which that control applies:

E = Existence or occurrence

C = Completeness

R = Rights and obligations

V = Valuation or allocation

P = Presentation and disclosure

.28 The processes, documents, and controls listed on this questionnaire are typical for governmental 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 entity's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.29

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Purchases and Accounts Payable</b>				
<b>A. Initiating Purchases and Receipts of Goods</b>				
1. Access to the master vendor file is limited to employees authorized to make changes. (E, C)	_____	_____	_____	_____
2. Responsibilities for the requisitioning and receiving functions are segregated from the purchasing, invoice processing, accounts payable, and general ledger functions. (E, C)	_____	_____	_____	_____
3. Purchasing authorizations are structured to give appropriate recognition to the nature and size of purchases and the experience of the purchasing personnel. (E, C)	_____	_____	_____	_____
4. If practical, contract or purchasing officer's areas of responsibility are rotated on a regular basis. (E, C)	_____	_____	_____	_____
5. A qualified employee or independent firm is engaged to inspect and monitor technically complex projects. (E, C, V)	_____	_____	_____	_____
6. Approval procedures exist for purchase order and contract issuance. (E, C)	_____	_____	_____	_____
7. Purchase requisitions are pre-numbered and those numbers are controlled. (E, C)	_____	_____	_____	_____



	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
8. Purchases of goods and services are initiated by properly authorized requisitions bearing the approval of officials designated to authorize requisitions. (E, C)	_____	_____	_____	_____
9. The appropriation to be charged is indicated on the purchase requisition by the person requesting the purchase. (E, C, P)	_____	_____	_____	_____
10. Before commitment, unobligated funds remaining under the appropriation are verified by the accounting or budget department as sufficient to meet the proposed expenditure. (P)	_____	_____	_____	_____
11. Procedures exist to ensure that funds received are spent in accordance with legal requirements and spending restrictions. (C, P)	_____	_____	_____	_____
12. Encumbrance (obligation) entries are recorded only on the basis of approved purchase orders. (E, P)	_____	_____	_____	_____
13. Competitive bidding procedures are used. (V)	_____	_____	_____	_____
14. Price lists and other appropriate records of price quotations are maintained by the purchasing department. (V)	_____	_____	_____	_____
15. Requests for special purpose (nonshelf items) materials or personal services are accompanied by technical specifications. (E, V)	_____	_____	_____	_____
16. Procedures exist for public advertisement of nonshelf item procurements in accordance with legal requirements. (E, V)	_____	_____	_____	_____
17. 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. (E, V)	_____	_____	_____	_____
18. The right to audit contractor records during project performance is exercised. (E, V)	_____	_____	_____	_____
19. Predetermined selection criteria exist for awarding personal service contracts and adequate documentation of the award process is required. (E)	_____	_____	_____	_____
20. Purchase orders and contracts are issued under numerical or some other suitable control. (E, C)	_____	_____	_____	_____
21. Splitting orders to avoid higher levels of approval is prohibited. (P)	_____	_____	_____	_____
22. Purchases made for the accommodation of employees are prohibited or adequately controlled. (E, V)	_____	_____	_____	_____
23. Changes to contracts or purchase orders are subjected to the same controls and approvals as the original agreement. (E, C, V)	_____	_____	_____	_____
24. Controls exist to notify department heads of payments made against encumbrances (obligations). (E, V, P)	_____	_____	_____	_____
25. An adequate record of open purchase orders and purchase agreements is maintained to ensure knowledge of outstanding commitments. (E, C, R, V, P)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
26. Trial balances of reserves for encumbrances (obligations) are prepared on a regular basis. (E, V, P)	_____	_____	_____	_____
27. Receiving reports are prepared for all purchased goods. (E, C)	_____	_____	_____	_____
28. Someone other than the individual that approves payments verifies that goods and services have been received, prices are as ordered, and the goods and services meet quality standards. (E, C, R, V)	_____	_____	_____	_____
29. Receiving reports are numerically accounted for or otherwise controlled to ensure that all receipts are reported to the accounting department. (E, C, R, V)	_____	_____	_____	_____
30. Copies of receiving reports are sent directly to purchasing, accounting, and, if appropriate, inventory record keeping. (E, C, R, V)	_____	_____	_____	_____
31. There are controls to record and follow up on partial deliveries. (E, C, R, V)	_____	_____	_____	_____
32. Controls exist for filing claims against carriers or vendors for shortages or damaged materials. (E, R, V)	_____	_____	_____	_____
33. The accounting and purchasing departments are promptly notified of returned purchases, and such purchases are correlated with vendor credit advices. (E, R, V)	_____	_____	_____	_____
34. A permanent record of material received is maintained. (E, C, R, V)	_____	_____	_____	_____
<b>B. Processing Purchases</b>				
35. Responsibilities for the invoice processing and accounts payable functions are segregated from those for recording cash disbursements and general ledger entries. (E, C, R, V, P)	_____	_____	_____	_____
36. All invoices are received from vendors in a central location, such as the accounting department. (E, C)	_____	_____	_____	_____
37. Invoice processing controls provide for—				
a. Obtaining copies of purchase orders and receiving reports directly from issuing departments. (E, C)	_____	_____	_____	_____
b. Comparison of invoice quantities, prices, and terms with those indicated on the purchase order. (E, C, V)	_____	_____	_____	_____
c. Comparison of invoice quantities with those indicated on the receiving reports. (E, C, V)	_____	_____	_____	_____
d. Checking the accuracy of calculations. (V)	_____	_____	_____	_____
38. A senior employee reviews and approves invoices by checking the clerical accuracy and examining the supporting documentation. (E, C, V)	_____	_____	_____	_____
39. Differences in invoice and purchase order prices, terms, shipping arrangements, and quantities are referred to purchasing for review and approval. (E, C, V)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
40. If an invoice is received from a supplier not previously dealt with, steps are taken to ascertain that the supplier actually exists. (E)	_____	_____	_____	_____
41. Controls exist for submission and approval of reimbursements to employees for travel and other expenses. (E, V)	_____	_____	_____	_____
42. Controls exist for processing invoices not involving materials or supplies (for example, lease or rental payments and utility bills). (E, C)	_____	_____	_____	_____
43. Control is established by the accounting department over invoices received before releasing them for departmental approval and other processing. (E, C, V)	_____	_____	_____	_____
44. Controls exist ensuring accurate account distribution of all entries resulting from invoice processing. (E, V, P)	_____	_____	_____	_____
45. Entries are posted to the accounting system on a timely basis. (E, C, R, V, P)	_____	_____	_____	_____
46. Responsibility is fixed for seeing that all cash discounts are taken and, if applicable, that exemptions from sales, federal excise, and other taxes are claimed. (V)	_____	_____	_____	_____
47. Statements from vendors are compared on a regular basis with recorded amounts payable. (E, C, V)	_____	_____	_____	_____
48. Responsibilities for the disbursement approval function are segregated from those for the disbursement preparation function. (E, C, V)	_____	_____	_____	_____
49. Controls exist ensuring that the accounts payable system is properly accounting for unmatched receiving reports and invoices. (E, C, R, V)	_____	_____	_____	_____
50. The accounting department maintains a current list of those authorized to approve expenditures. (E)	_____	_____	_____	_____
51. The program and expenditure account to be charged is reviewed for propriety and budget conformity. (P)	_____	_____	_____	_____
52. Procedures exist to ensure adjustment of the reserve for encumbrances (obligations) when invoices are prepared for payment. (E, V, P)	_____	_____	_____	_____
53. Controls exist ensuring that department heads are notified of payments made against accounts payable and encumbrances (obligations). (E, V, P)	_____	_____	_____	_____
54. Transactions between funds are posted in all affected funds in the same accounting period and on a timely basis. (E, C, R, V, P)	_____	_____	_____	_____
55. Trial balances of accounts payable are prepared on a regular basis. (C, R, V, P)	_____	_____	_____	_____
56. Trial balances of accounts payable are checked and traced to the individual items as well as compared in total to the general ledger balance by an employee other than the accounts payable clerk. (E, C, R, V, P)	_____	_____	_____	_____

## II. Cash Disbursements

1. Procedures exist for disbursement approval and warrant or check-signing. (E, C, V)
2. Responsibilities for the disbursement approval function are segregated from those for the disbursement, voucher preparation, and purchasing functions. (E, C, V)
3. Responsibilities for entries in the cash disbursement records are segregated from those for general ledger entries. (E, C, V)
4. Controls are maintained over the supply of unused and voided warrants or checks. (E, C)
5. Original invoices and supporting documents are furnished to the signer prior to signing the warrant or check. (E, C, V)
6. Warrants or checks are cross-referenced to invoices. (E, V)
7. Invoices and supporting documents are canceled by or in the presence of the check signer at the time of signing. (E, V)
8. Controls exist to ensure that warrants or checks that have been signed and issued are recorded promptly. (E, C, R, V, P)
9. The drawing of warrants or checks to cash or bearer is prohibited. (E)
10. Control exists over warrant or check-signing machines as to signature plates and usage. (E)
11. The check-signing machine is 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. (E)
12. Reasonable limits are set on amounts that can be paid by a check-signing machine. (E)
13. Two signatures are required on warrants or checks over a stated amount. (E)
14. Signed warrants or checks are delivered directly to the mailroom making them inaccessible to persons who requested, prepared, or recorded them. (E)
15. Controls exist to notify banks when a new signer is authorized or a previous signer leaves the employ of the government or is otherwise no longer authorized to sign. (E)
16. Responsibilities for entries in the cash disbursement records are segregated from those for general ledger entries. (E, C, R, V, P)

<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
_____	_____	_____	_____
_____	_____	_____	_____
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_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>III. Grants Received and Made<sup>1</sup></b>				
1. Grant disbursements are processed under the same degree of controls applicable to the organization's other transactions (budget, procurement, and so forth). (E, C, R, V, P)	_____	_____	_____	_____
2. Procedures are modified when funds are disbursed under grant or loan agreements and related regulations impose requirements that differ from the entity's normal policies. (E, C, P)	_____	_____	_____	_____
3. Controls are established to ensure that costs charged to grants are in compliance with grant agreements. (E, C, P)	_____	_____	_____	_____
4. There a system for obtaining grantor approval before incurring expenditures in excess of budgeted amounts or for unbudgeted expenditures. (E, C, P)	_____	_____	_____	_____
5. Procedures exist to identify, before order entry, costs and expenditures that are not allowable under grant programs. (E, C, P)	_____	_____	_____	_____
6. If an indirect cost allocation plan is established, it has been developed in accordance with grantor requirements and approved as required by the grantor. (E, C, V, P)	_____	_____	_____	_____
7. Grant activity is accounted for so that it can be separated from the accounting for locally funded activities. (E, C, V, P)	_____	_____	_____	_____
8. Procedures and controls exist to monitor compliance with grant requirements. (E, C, P)	_____	_____	_____	_____
9. The level of authority for approving grants and subgrants appears appropriate. (E, C, P)	_____	_____	_____	_____
10. Controls exist to ensure that statistics or data used to allocate grant or subgrant funds to recipients are accurately accumulated (for example, census bureau forms). (E, C, V, P)	_____	_____	_____	_____
11. Compliance requirements are defined (for example, regulations) and communicated to recipients. (C, P)	_____	_____	_____	_____
12. The responsibility for monitoring recipient activities is properly fixed. (C, P)	_____	_____	_____	_____
13. Grant and subgrant activity is monitored from a centralized location. (E, C, R)	_____	_____	_____	_____
14. Grant and subgrant payments are disbursed only on the basis of approved applications. (E, C, V)	_____	_____	_____	_____
15. Funds are disbursed to recipients only on an as needed basis. (C, P)	_____	_____	_____	_____

<sup>1</sup> This section need not be completed if the auditor is conducting an audit in accordance with the provisions of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, concurrently with the financial statement audit, and the scope of that A-133 audit is sufficient to provide reasonable assurance concerning the entity's compliance with grant requirements that have a direct and material effect on financial statement amounts. See instead AAM section 12,040.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
16. Procedures exist to monitor recipient compliance with grant terms. (C, P)	_____	_____	_____	_____
17. Recipients are subject to periodic and timely audits. (E, C, R, V, P)	_____	_____	_____	_____
18. Recipients are required to correct previously detected deficiencies before a grant or subgrant is extended or renewed. (E, R, P)	_____	_____	_____	_____
19. Recipients are required to file statements of compliance with entitlement conditions and a responsible official reviews them. (C, P)	_____	_____	_____	_____
20. Audited financial statements and other reports from recipients are reviewed on a timely basis and unusual items are investigated. (E, C, R, V, P)	_____	_____	_____	_____
21. Audits of contractors cover compliance with regulations (such as the Equal Employment Opportunity and Davis-Bacon Acts) and contract terms, in addition to costs. (E, C, R, V, P)	_____	_____	_____	_____

## End User Computing in the Purchasing Cycle

.30 End user computing occurs when the user is responsible for developing and executing a computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that calculates the difference between lease expenditures and cash disbursements for leases, and that difference is the source of a journal entry.

.31 *Computer Applications Form—Governmental Units* [AAM section 12,020] was used to document your understanding of computer applications operated by the entity's data processing department. In this section of the Financial Reporting Information Systems and Controls Form, you may document your understanding of how end user computing is used in the purchasing cycle to process significant accounting information outside of the data processing 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 data processing department—operated accounting application. For example, a database calculates the cash disbursement for lease payments based on the provisions of the lease agreement.
- Make significant accounting decisions. For example, a spreadsheet calculates the journal entry to be made for lease expenditures based on generally accepted accounting principles.
- Accumulate footnote information. For example, a database of lease obligations provides information for note disclosure.

.33 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 (for example, spreadsheet).



- 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.

	19__	19__	20__	20__
Prepared or updated by:				
Reviewed by:				

## Cash and Investments

**.37** This form may be used on any audit engagement of a governmental entity when cash and investment balances or transactions are significant.

**.38** The purpose of this form is to document your understanding of controls for significant classes of transactions. Your knowledge of cash and investments should be sufficient for you to understand—

- How the entity ensures compliance with legal and contractual requirements over cash and investment transactions.
- How cash accounts are managed and reconciled.
- How investment decisions are authorized and initiated.
- How investment transactions are processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of investments.
- The processes used to prepare financial statement disclosures and presentations relating to cash and investments.

## Interpreting Results

**.39** This form documents your understanding of how internal control over cash and investments is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. In entities where a significant amount of 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). Because 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 financial statement 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. If you plan a lower control risk assessment for certain assertions relating to cash and investments, the following checklist uses the following coding to identify parenthetically after the control the financial statement assertions to which that control applies:

E = Existence or occurrence

C = Completeness

R = Rights and obligations

V = Valuation or allocation

P = Presentation and disclosure

.40 The processes, documents, and controls listed on this questionnaire are typical for governmental 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 entity's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

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	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Cash and Investments</b>				
1. Controls exist to ensure that cash and investment transactions are recorded on a timely basis. (E, C, R, V)	_____	_____	_____	_____
2. Procedures exist for reconciling detailed cash and investment accounting records with the general ledger. (E, C, R, V)	_____	_____	_____	_____
3. Individuals with access to cash accounts and investments are bonded. (C, R, V)	_____	_____	_____	_____
4. There is adequate control over the allocation among funds of pooled cash and investments. (R, P)	_____	_____	_____	_____
<b>II. Cash</b>				
1. Bank accounts are properly authorized. (C)	_____	_____	_____	_____
2. Depositories are periodically reviewed and formally reauthorized. (C)	_____	_____	_____	_____
3. Procedures exist to review bank balances for appropriate insurance and collateral on a periodic basis. (R, P)	_____	_____	_____	_____
4. Procedures exist for authorizing and recording inter-bank transfers and for providing for proper accounting for those transactions. (E, C, R, V, P)	_____	_____	_____	_____
5. Responsibilities for preparing and approving bank account reconciliations are segregated from those for other cash receipt or disbursement functions. (E, C, V)	_____	_____	_____	_____
6. Bank statements and paid warrants or checks are delivered in unopened envelopes directly to the employee preparing the reconciliation. (E, C, V)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
7. Procedures exist for steps essential to an effective bank statement reconciliation, particularly—				
<i>a.</i> Comparison of warrants or checks in appropriate detail with disbursement records. (C, V)	_____	_____	_____	_____
<i>b.</i> Examination of signature and endorsements, at least on a test basis. (E, R)	_____	_____	_____	_____
<i>c.</i> Accounting for numerical sequence of warrants or checks used. (C)	_____	_____	_____	_____
<i>d.</i> Comparison of book balances used in reconciliations with general ledger accounts. (E, C, V)	_____	_____	_____	_____
<i>e.</i> Comparison of deposit amounts and dates with cash receipt entries. (C, V)	_____	_____	_____	_____
<i>f.</i> Footing of cash books. (C, V)	_____	_____	_____	_____
8. All reconciliations and investigations of unusual reconciling items are reviewed and approved (by signature) by an official who is not responsible for receipts and disbursements. (E, C, R, V)	_____	_____	_____	_____
9. Checks outstanding for a considerable time periodically are reviewed for propriety. (E)	_____	_____	_____	_____
10. Cancelled checks are subject to appropriate escheat procedures. (R, P)	_____	_____	_____	_____
11. Controls and physical safeguards exist surrounding petty cash funds. (E, C)	_____	_____	_____	_____

### III. Investments

1. Investment policies are formally established and periodically reviewed. (R, P)	_____	_____	_____	_____
2. Procedures are adequate to ensure that only investments that are permitted by law are acquired. (R, P)	_____	_____	_____	_____
3. The entity's investment program is integrated with its cash management program and expenditure requirements. (E, C, V)	_____	_____	_____	_____
4. Authority and responsibility has been established for investment opportunity evaluation and purchase. (E, V)	_____	_____	_____	_____
5. Procedures have been established governing the level and nature of approvals required to purchase or sell investments. (E, V)	_____	_____	_____	_____
6. Competitive bids are sought for investment purchases. (E, V)	_____	_____	_____	_____
7. Responsibilities for initiating, evaluating, and approving investment transactions are segregated from those for detail accounting, general ledger, and other related functions. (E, C, R, V, P)	_____	_____	_____	_____
8. Responsibilities for initiating investment transactions are segregated from those for final approvals that commit government resources. (E)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
9. Adequate physical safeguards and custodial procedures exist over—				
a. Negotiable and nonnegotiable securities owned. (E, C, R)	_____	_____	_____	_____
b. Legal documents or agreements evidencing ownership or other rights. (E, C, R)	_____	_____	_____	_____
10. Dual signatures or authorizations are required to obtain the release of securities from safekeeping or to obtain access to the entity's safe deposit box. (E, C, R)	_____	_____	_____	_____
11. Persons with access to securities are authorized by the governing board. (E, C, R)	_____	_____	_____	_____
12. Custodial responsibilities for securities and other documents evidencing ownership or other rights are assigned to an official who has no accounting duties. (E, C, R)	_____	_____	_____	_____
13. All securities are registered or held in the name of the entity. (E, R)	_____	_____	_____	_____
14. Securities are periodically inspected or confirmed with safekeeping agents. (E, C, R)	_____	_____	_____	_____
15. Periodic comparisons are made between income received and the amount specified by the terms of the security or publicly available investment information. (E, C, V)	_____	_____	_____	_____
16. Responsibilities for monitoring investment fair values and performance are segregated from those for investment acquisition. (R, V)	_____	_____	_____	_____
17. The performance of the investment portfolio is periodically evaluated by persons independent of the investment portfolio management activities. (E, C, R, V)	_____	_____	_____	_____
18. Detailed accounting records are maintained for investments. (E, C, R, V, P)	_____	_____	_____	_____
19. Responsibilities for maintaining detail investment accounting records are segregated from those for general ledger entries. (E, C, R, V, P)	_____	_____	_____	_____
20. Detailed accounting records for investments are periodically agreed (or reconciled) to the general ledger records and that agreement/reconciliation is reviewed by a person independent of the investment management and accounting functions. (E, C, R, V, P)	_____	_____	_____	_____
21. Procedures exist to ensure that transactions arising from investments are properly processed, including income and amortization entries. (E, C, R, V, P)	_____	_____	_____	_____
22. Controls exist to ensure that investment earnings are credited to the appropriate fund. (E, C, R, V, P)	_____	_____	_____	_____
23. Appropriate procedures exist to determine the fair value of investments (including, if deemed necessary, confirmation of those fair values with a second source). (V)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
24. Controls exist to review investments carried at cost-based measures for other-than-temporary declines and to appropriately write down the values of those investments. (V)	_____	_____	_____	_____
25. Management periodically reviews the fair values of investments. (V)	_____	_____	_____	_____
26. The entity has an established policy for reporting investments as cash and cash equivalents. (P)	_____	_____	_____	_____

## End User Computing for Cash and Investments

.42 End user computing occurs when the user is responsible for developing and executing a computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that calculates the journal entry to amortize purchased discounts and premiums for investments that are reported using cost-based measures.

.43 *Computer Applications Form—Governmental Units* [AAM section 12,020] was used to document your understanding of computer applications operated by the entity's data processing department. In this section of the Financial Reporting Information Systems and Controls Form, you may document your understanding of how end user computing is used for cash and investments to process significant accounting information outside of the data processing 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 data processing department-operated accounting application. For example, a spreadsheet calculates the daily investment purchases and sales for a single journal entry into the general ledger.
- Make significant accounting decisions. For example, a spreadsheet calculates the journal entry to amortize purchased discounts and premiums for investments that are reported using cost-based measures.
- Accumulate footnote information. For example, a database of insurance and collateral on depository accounts provides information for note disclosure.

.45 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 (for example, spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

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## Procedures and Controls Over End User Computing

.46 Answer the following questions relating to procedures and controls over end user computing related to cash and investments . . .

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Cash and Investments</b>				
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 *Computer Applications Form—Governmental Units* [AAM section 12,020] was used to document your understanding of the entity'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 cash and investments.

.48 In the space below, describe the cash and investments information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.

- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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Prepared or updated by:	_____	_____	_____	_____
Reviewed by:	_____	_____	_____	_____

## Fixed Assets

.49 This form may be used on any audit engagement of a governmental entity when fixed assets are significant.

.50 The purpose of this form is to document your understanding of controls for significant classes of transactions. Your knowledge of controls over fixed assets 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 in the form for the purchasing cycle—AAM section 12,030.25.)
- How fixed asset transactions and depreciation is processed by the accounting system.
- The accounting records and supporting documents involved in the processing and reporting of fixed assets and depreciation.
- The process used to prepare significant accounting estimates and disclosures.

## Interpreting Results

.51 This form documents your understanding of how internal control over fixed assets is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. In entities where a significant amount of 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). Because 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 financial statement 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. If you plan a lower control

risk assessment for certain assertions relating to fixed assets, the following checklist uses the following coding to identify parenthetically after the control the financial statement assertions to which that control applies:

E = Existence or occurrence

C = Completeness

R = Rights and obligations

V = Valuation or allocation

P = Presentation and disclosure

.52 The processes, documents, and controls listed on this questionnaire are typical for governmental 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 entity's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

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	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Fixed Assets</b>				
<b>A. Authorization and Initiation</b>				
1. A separate capital budget is prepared. (P)	_____	_____	_____	_____
2. Written executive or legislative approval is required for all significant fixed asset projects or acquisitions. (E)	_____	_____	_____	_____
3. Responsibilities for initiating, evaluating, and approving capital expenditures, leases, and maintenance or repair projects are segregated from those for project accounting, property records, and general ledger functions. (E)	_____	_____	_____	_____
4. Those individuals authorized to initiate fixed asset transactions are identified and there is clear definition of the limits of their authority. (E)	_____	_____	_____	_____
5. Responsibilities for initiating fixed asset transactions are segregated from those for final approvals that commit government resources. (E)	_____	_____	_____	_____
6. Controls exist to—				
a. Distinguish between capital budget expenditures and operating budget expenditures. (E, C, P)	_____	_____	_____	_____
b. Identify operating budget expenditures to be capitalized as fixed assets. (P)	_____	_____	_____	_____
c. Distinguish between capital and operating leases. (P)	_____	_____	_____	_____
7. An adequate number of price quotations are obtained before placing orders not subject to competitive bidding. (V)	_____	_____	_____	_____
8. Guidelines are established with respect to key considerations for fixed asset acquisitions, 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. (E, R, V, P)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
9. Controls exist ensuring that purchased materials and services for capital expenditure and repair projects are subject to the same levels of controls as exist for all other procurements (for example, receiving, approval, checking). (E, C)	_____	_____	_____	_____
10. Controls exist providing for obtaining grantor approval, if required, for the use of grant funds for fixed asset acquisitions. (C, P)	_____	_____	_____	_____
11. Grant-funded authorizations are subject to the same controls as internally funded acquisitions. (E, C, R, V, P)	_____	_____	_____	_____
12. Supplemental authorizations are required, including, if appropriate, those of the grantor agency, for expenditures in excess of originally approved amounts. (E, C, P)	_____	_____	_____	_____
13. If construction contracts are to be awarded, bid and performance bonds are considered. (E)	_____	_____	_____	_____
14. Predetermined selection criteria exist for awarding construction contracts and adequate documentation of the award process is required. (E)	_____	_____	_____	_____
15. Lease transactions are subject to control procedures similar to those required for other capital expenditures. (E, C, R, V, P)	_____	_____	_____	_____

**B. Processing and Documentation**

1. The general ledger and detailed fixed assets records are updated for fixed asset transactions (including the completion of construction projects) on a timely basis. (E, C, R, V, P)	_____	_____	_____	_____
2. The accounting distribution is reviewed to ensure proper allocation of charges to fixed asset and expenditure projects. (V, P)	_____	_____	_____	_____
3. If construction work is performed by contractors, controls exist to provide for and maintain control over construction projects and progress billings (for example, requests for progress payments relate to contractors' efforts and they are formally approved). (E, R, V)	_____	_____	_____	_____
4. Project cost records are established and maintained for capital expenditure and repair projects. (E, C, V)	_____	_____	_____	_____
5. Responsibilities for project accounting and property records are segregated from the general ledger and custodial functions. (E, C, R, V, P)	_____	_____	_____	_____
6. Detailed property records are maintained for all significant self-constructed, donated, purchased, or leased assets. (E, C, R, V, P)	_____	_____	_____	_____
7. The accountability for each asset is established. (E, C)	_____	_____	_____	_____
8. Physical safeguards over assets exist. (E, C)	_____	_____	_____	_____
9. Equipment is properly identified by metal numbered tags or other means of positive identification. (E)	_____	_____	_____	_____



	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
10. Procedures exist to ensure that fixed assets are adequately insured. (E, C)	_____	_____	_____	_____
11. Periodic inventories of fixed assets are taken and inventory results are compared to the detailed property records. (E, C, R)	_____	_____	_____	_____
12. Responsibilities for the periodic physical inventories of fixed assets is assigned to responsible officials who have no custodial or record keeping responsibilities. (E, C, R)	_____	_____	_____	_____
13. Differences between records and physical counts are investigated, the records adjusted to reflect differences, and adjustments are reviewed by management. (E, R, V)	_____	_____	_____	_____
14. Controls exist for periodic inventory of documents evidencing property rights (for example, deeds, leases, and the like). (E, C, R)	_____	_____	_____	_____
15. Detailed property records are periodically reconciled with the general ledger control accounts. (E, C, V)	_____	_____	_____	_____
16. Controls exist to govern depreciation methods and practices. (V)	_____	_____	_____	_____
17. If costs are expected to be charged against federal grants, depreciation policies or methods of computing allowances are in compliance with the standards outlined in OMB circulars or grantor agency regulations or depreciation charged to grants is adjusted accordingly. (R, V, P)	_____	_____	_____	_____
18. Fully depreciated assets are carried in the accounting records as a means of providing accounting control. (E, C)	_____	_____	_____	_____
<b>C. Dispositions</b>				
1. Controls exist for authorizing, approving, and documenting sales or other dispositions of fixed assets. (E)	_____	_____	_____	_____
2. Controls exist for monitoring the appropriate disposition of property acquired with grant funds. (E, R, P)	_____	_____	_____	_____
3. The accounting records are adjusted promptly—both the asset and related allowance for depreciation—when fixed assets are retired, sold, or transferred. (E, R, V)	_____	_____	_____	_____

## End User Computing for Fixed Assets

**.54** End user computing occurs when the user is responsible for developing and executing a computer application that generates the information used by that same person. For example, an accounting clerk prepares a spreadsheet that calculates depreciation for fixed assets.

**.55** *Computer Applications Form—Governmental Units* [AAM section 12,020] was used to document your understanding of computer applications operated by the entity's data processing department. In this section of the Financial Reporting Information Systems and Controls Form, you may document your understanding of how end user computing is used for fixed assets to process significant accounting information outside of the data processing 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 data processing department-operated accounting application. For example, a spreadsheet accumulates the monthly fixed assets purchases and sales for a single journal entry into the general ledger.
- Make significant accounting decisions. For example, a spreadsheet calculates the depreciation charge for fixed assets.
- Accumulate footnote information. For example, a database of detailed fixed asset records provides information for disclosure of the major classes of fixed assets.

**.57** In the space provided below, describe how end user computing is used for fixed assets. Describe—

- The person or department who performs the computing.
- A general description of the application and its type (for example, spreadsheet).
- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

[illegible]

## Procedures and Controls Over End User Computing

.58 Answer the following questions relating to procedures and controls over end user computing related to fixed assets.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>Fixed Assets</b>				
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.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
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** *Computer Applications Form—Governmental Units* [AAM section 12,020] was used to document your understanding of the entity'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 fixed assets.

**.60** In the space below, describe the fixed asset information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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Prepared or updated by:

Reviewed by:

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## Payroll Cycle

**.61** This form may be used on any audit engagement of a governmental entity when the payroll cycle is significant. The payroll cycle is usually significant in governmental audit engagements.

**.62** The purpose of this form is to document your understanding of controls for significant classes of transactions. Your knowledge of controls over the payroll cycle should be sufficient for you to understand—

- How salaries and hourly rates are established.
- How the time worked by employees is captured by the accounting system.

- 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 form 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 a significant amount of 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). Because 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 financial statement 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. If you plan a lower control risk assessment for certain assertions relating to the payroll cycle, the following checklist uses the following coding to identify parenthetically after the control the financial statement assertions to which that control applies:

E = Existence or occurrence

C = Completeness

R = Rights and obligations

V = Valuation or allocation

P = Presentation and disclosure

.64 The processes, documents, and controls listed on this questionnaire are typical for governmental 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 entity's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

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	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
<b>I. Payroll</b>				
<b>A. Initiating Payroll Transactions</b>				
1. Wages and salaries are approved by the governing board as part of the budget process. (E, V)	_____	_____	_____	_____
2. Bonuses and employee benefits are authorized by the governing board. (E, V)	_____	_____	_____	_____
3. All changes in employment (additions and terminations), salary and wage rates, and payroll deductions are properly authorized, approved, and documented. (E, C, V)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
4. Notices of additions, separations, and changes in salaries, wages, and deductions are promptly reported to the payroll-processing function. (E, C, V)	_____	_____	_____	_____
5. Changes to the master payroll file are approved and documented. (E, V)	_____	_____	_____	_____
6. Access to the master payroll file is limited to employees who are authorized to make changes. (E, V)	_____	_____	_____	_____
7. Wages are at or above the federal minimum wage. (V)	_____	_____	_____	_____
8. Responsibilities for supervision and timekeeping functions are segregated from personnel, payroll processing, disbursement, and general ledger functions. (E, C)	_____	_____	_____	_____
9. Records and controls exist for timekeeping and attendance. (E, C)	_____	_____	_____	_____
10. If time cards are used, they are punched only by the employees to whom they are issued. (E)	_____	_____	_____	_____
11. The time clock is placed in a position where it can be observed by a supervisor. (E)	_____	_____	_____	_____
12. Hours worked, overtime hours, and other special benefits are reviewed and approved by the employee's supervisor. (E, C, V)	_____	_____	_____	_____
13. Appropriate payroll records are maintained for accumulated employee benefits (vacation, pension data, and so forth). (E, C, R)	_____	_____	_____	_____
14. Procedures exist for authorizing, approving, and recording vacations, holidays, sick leave, and compensatory time. (E, C, R, V, P)	_____	_____	_____	_____
15. Terminating employees are interviewed by the personnel department as a check on departure and as a final review of any termination settlement. (E, C, V)	_____	_____	_____	_____
<b>B. Processing Payroll</b>				
1. Controls exist over payroll preparation. (E, C, R, V, P)	_____	_____	_____	_____
2. Responsibilities for the payroll processing function are segregated from the general ledger function. (E, C, R, V)	_____	_____	_____	_____
3. Payroll is calculated using authorized pay rates, payroll deductions, and time records. (E, C, R, V)	_____	_____	_____	_____
4. There are adequate account coding procedures to ensure proper classification of employee compensation and benefit costs in general ledger accounts. (P)	_____	_____	_____	_____
5. Controls exist to ensure that employee benefit and compensation costs do not exceed appropriated or budgeted amounts. (V, P)	_____	_____	_____	_____
6. The distribution of costs to general ledger accounts is balanced with the payroll registers, and reviewed by someone independent but knowledgeable in this area. (V, P)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
7. Completed payroll registers are reviewed and approved before disbursements are made. (E, C, R)	_____	_____	_____	_____
8. Comparisons (reconciliations) of gross pay of current and prior period payrolls are reviewed for reasonableness by a knowledgeable person not otherwise involved in payroll processing. (E, C, R, V)	_____	_____	_____	_____
9. The payroll (including an examination of authorization of changes on reconciliations) is reviewed by an employee not involved in its preparation. (E, C, R, V)	_____	_____	_____	_____
10. Payroll advances to officials and employees are prohibited or they are subject to appropriate review. (E)	_____	_____	_____	_____
11. Responsibilities for initiating payments under employee benefit plans are segregated from accounting and general ledger functions. (E, C, V)	_____	_____	_____	_____
12. Accrued liabilities for unpaid employee compensation and benefit costs are properly recorded and disclosed. (E, C, R, V, P)	_____	_____	_____	_____
13. Documents supporting employee benefit payments (such as accumulated vacation or sick leave) are reviewed before disbursements are made. (E, C, V)	_____	_____	_____	_____
14. The counter on the check-signing machine is reconciled with the number of checks issued in each payroll. (E, C)	_____	_____	_____	_____
15. Signature plates and the use of the payroll check-signing machines are kept under control of the official whose name appears on the signature plate (or his/her designee). (E)	_____	_____	_____	_____
16. The supply of unused payroll checks is controlled. (E, C)	_____	_____	_____	_____
17. A separate, imprest-basis, payroll bank account is maintained. (E, C, V)	_____	_____	_____	_____
18. The payroll bank account is reconciled regularly by employees independent of all other payroll transaction processing activities. (E, C, V)	_____	_____	_____	_____
19. Payroll check endorsements are compared, on a test basis, with signatures on file by someone independent of the payroll department. (E)	_____	_____	_____	_____
20. Responsibilities for payroll distribution are segregated from personnel, timekeeping, and payroll processing functions. (E)	_____	_____	_____	_____
21. Payroll checks are periodically distributed by the internal auditors to ascertain that employees exist for all checks prepared. (E)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
22. Employees are required to provide identification before being given checks or pay envelopes. (E)	_____	_____	_____	_____
23. Employees are prohibited from accepting another employee's pay. (E)	_____	_____	_____	_____
24. Unclaimed wages are returned to a custodian independent of the payroll department. (E, P)	_____	_____	_____	_____
25. Employees who distribute checks or pay envelopes make a report of unclaimed wages directly to the accounting department. (E, P)	_____	_____	_____	_____
26. Unclaimed wages are paid at a later date only upon presentation of appropriate evidence of employment and those payments are approved by an officer or employee who is not responsible for payroll preparation or time reporting. (E)	_____	_____	_____	_____
27. W-2 forms are compared to payroll records and mailed by employees not otherwise involved in the payroll process. (E, V)	_____	_____	_____	_____
28. Procedures exist for investigating returned W-2s. (E, V)	_____	_____	_____	_____

## End User Computing in the Payroll Cycle

**.66** End user computing occurs when the user is responsible for developing and executing a computer application that generates the information used by that same person. For example, a payroll clerk prepares a spreadsheet that calculates the first payroll for newly hired employees that provides the basis for manual checks and a journal entry into the accounting system.

**.67** *Computer Applications Form—Governmental Units* [AAM section 12,020] was used to document your understanding of computer applications operated by the entity's data processing department. In this section of the Financial Reporting Information Systems and Controls Form, you may document your understanding of how end user computing is used for the payroll cycle to process significant accounting information outside of the data processing department.

**.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 data processing department-operated accounting application. For example, a spreadsheet accumulates time card information for batch processing.
- Make significant accounting decisions. For example, a spreadsheet calculates the compensated absences liability.
- 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 (for example, spreadsheet).

[illegible][illegible]



**.72** In the space below, describe the fixed asset information processed by the outside computer service bureau. Discuss—

- The general nature of the application.
- The source documents used by the service organization.
- The reports or other accounting documents produced by the service organization.
- The nature of the service organization's responsibilities. Do they merely record entity transactions and process related data, or do they have the ability to initiate transactions on their own?
- Controls maintained by the entity to prevent or detect material misstatement in the input or output.

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	19__	19__	20__	20__
Prepared or updated by:	_____	_____	_____	_____
Reviewed by:	_____	_____	_____	_____

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*[The next page is 12,100-101.]*



# AAM Section 12,040

## *Internal Control Checklist—Federal Awards (OMB Circular A-133 Single Audits)*

.01 Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, requires the auditee to maintain internal control over federal programs that provides reasonable assurance that it is managing its federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs.

.02 Circular A-133 also requires the auditor—in addition to the requirements of generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General—to:

- Perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- Plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform testing of the internal control over compliance as planned unless internal control over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance. (However, if such internal control is likely to be ineffective, Circular A-133 requires the auditor to report a reportable condition [including whether any such condition is a material weakness], assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.)

.03 The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control over compliance for programs that are not considered major, or to plan or perform any testing of internal control over compliance for those programs except for (a) any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs and (b) follow-up on prior-year findings. However, a program that is not considered major could still be material to the financial statements. In that situation, in conjunction with the financial statement audit, the auditor may need to obtain an understanding of the internal control over financial reporting that is relevant to the program.

.04 Following are examples of characteristics of internal control that could reasonably assure compliance with federal laws, regulations, and program compliance requirements that are common to the fourteen types of compliance requirements identified in the May 1998 OMB *Compliance Supplement*. Internal control objectives and examples of characteristics specific to each of those fourteen types of compliance requirements are in paragraph .05. Answers that fall toward the right side of this checklist ("Strongly Agree" or "Somewhat Agree") indicate areas of strength in the entity's internal control. Answers that fall toward the left side of this checklist ("Strongly Disagree" or "Somewhat Disagree") indicate areas of weakness in the entity's internal control.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>A. Control Environment</b>					
1. The entity has a sense of conducting operations ethically, as evidenced by a code of conduct or other verbal or written directive.	_____	_____	_____	_____	_____
2. Management has responded positively to prior questioned costs and control recommendations.	_____	_____	_____	_____	_____
3. Management has respect for and adheres to program compliance requirements.	_____	_____	_____	_____	_____
4. Key managers' responsibilities are clearly defined.	_____	_____	_____	_____	_____
5. Key managers have adequate knowledge and experience to discharge their responsibilities.	_____	_____	_____	_____	_____
6. Staff is knowledgeable about compliance requirements and are given responsibility to communicate all instances of noncompliance to management.	_____	_____	_____	_____	_____
7. Management's commitment to competence ensures that staff receives adequate training to perform their duties.	_____	_____	_____	_____	_____
8. Management supports adequate information and reporting systems.	_____	_____	_____	_____	_____
<b>B. Risk Assessment</b>					
1. Program managers and staff understand and have identified key compliance objectives.	_____	_____	_____	_____	_____
2. The entity's organizational structure helps to identify risks of non-compliance—					
a. Key managers have been given responsibility to identify and communicate changes in program objectives and procedures.	_____	_____	_____	_____	_____
b. Employees who require close supervision (such as, those who are inexperienced) are identified.	_____	_____	_____	_____	_____
c. Management has identified and assessed complex operations, programs, or projects.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
d. Management is aware of results of monitoring, audits, and reviews and considers related risk of noncompliance.	_____	_____	_____	_____	_____
3. Management has established a process to implement changes in program objectives and procedures.	_____	_____	_____	_____	_____
4. The entity has established a process to assess and address potential year 2000 failures in computer systems and equipment affecting its federal programs.	_____	_____	_____	_____	_____
<b>C. Control Activities</b>					
1. Operating policies and procedures are clearly written and communicated.	_____	_____	_____	_____	_____
2. The entity has procedures in place to implement changes in laws, regulations, guidance, and funding agreements affecting federal awards.	_____	_____	_____	_____	_____
3. Management has a prohibition against intervention or overriding established controls.	_____	_____	_____	_____	_____
4. There is adequate segregation of duties provided between performance, review, and recordkeeping of tasks.	_____	_____	_____	_____	_____
5. Computer and program controls include—					
a. Data entry controls, such as, edit checks.	_____	_____	_____	_____	_____
b. Exception reporting.	_____	_____	_____	_____	_____
c. Access controls.	_____	_____	_____	_____	_____
d. Reviews of input and output data.	_____	_____	_____	_____	_____
e. Computer general controls and security controls.	_____	_____	_____	_____	_____
6. Supervision of employees is commensurate with their level of competence.	_____	_____	_____	_____	_____
7. Personnel have adequate knowledge and experience to discharge their responsibilities.	_____	_____	_____	_____	_____
8. Equipment, inventories, cash, and other assets are physically secured and periodically counted and compared to recorded amounts.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>D. Information and Communication</b>					
1. The accounting system provides for separate identification of federal and non-federal transactions and the allocation of transactions applicable to both.	_____	_____	_____	_____	_____
2. Adequate source documentation exists to support amounts and items reported.	_____	_____	_____	_____	_____
3. The entity has established a record-keeping system to ensure that accounting records and documentation are retained for the time period required by applicable requirements.	_____	_____	_____	_____	_____
4. Reports are provided to managers on a timely basis for review and appropriate action.	_____	_____	_____	_____	_____
5. Accurate information is accessible to those who need it.	_____	_____	_____	_____	_____
6. There are reconciliations and reviews to ensure the accuracy of reports.	_____	_____	_____	_____	_____
7. There are established internal and external communication channels, such as—					
a. Staff meetings.	_____	_____	_____	_____	_____
b. Bulletin boards.	_____	_____	_____	_____	_____
c. Memos, circulation files, e-mail.	_____	_____	_____	_____	_____
d. Surveys, suggestion box.	_____	_____	_____	_____	_____
8. Employees' duties and control responsibilities are effectively communicated.	_____	_____	_____	_____	_____
9. The entity has established channels of communication for people to report suspected improprieties.	_____	_____	_____	_____	_____
10. Actions are taken as a result of communications received.	_____	_____	_____	_____	_____
11. The entity has established channels of communication with its subrecipients.	_____	_____	_____	_____	_____
<b>E. Monitoring</b>					
1. Ongoing monitoring is built-in through the use of independent reconciliations, staff meeting feed back, rotating staff, supervisory review, and management review of reports.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
2. Periodic site visits are performed at decentralized locations (including subrecipients) and checks are performed to determine whether procedures are being followed as intended.	_____	_____	_____	_____	_____
3. The entity follows up on irregularities and deficiencies to determine the cause.	_____	_____	_____	_____	_____
4. Internal quality control reviews are performed.	_____	_____	_____	_____	_____
5. Management meets with program monitors, auditors, and reviewers to evaluate the condition of the program and controls.	_____	_____	_____	_____	_____
6. Internal audit routinely tests for compliance with federal requirements.	_____	_____	_____	_____	_____

.05

**A. Activities Allowed or Unallowed and B. Allowable Costs/Cost Principles**

1. *Control objectives*—To provide reasonable assurance that federal awards are expended only for allowable activities and that the costs of goods and services charged to federal awards are allowable and in accordance with the applicable cost principles.
2. *Control Environment*—
  - a. Management sets reasonable budgets for federal and non-federal programs so that no incentive exists to miscode expenditures. \_\_\_\_\_
  - b. Management enforces appropriate penalties for misappropriation or misuse of funds. \_\_\_\_\_
  - c. There is organization-wide awareness of the need for separate identification of allowable federal costs. \_\_\_\_\_
  - d. Management provides personnel who approve and pre-audit expenditures with a list of allowable and unallowable expenditures. \_\_\_\_\_
3. *Risk Assessment*—
  - a. There is a process for assessing risks resulting from changes to cost accounting systems. \_\_\_\_\_

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. A key manager has a sufficient understanding of staff, processes, and controls to identify where unallowable activities or costs could be charged to a federal program and not be detected.	_____	_____	_____	_____	_____
4. Control Activities—					
a. Accountability is provided for charges and costs between federal and non-federal activities.	_____	_____	_____	_____	_____
b. There is a process in place for timely updating of procedures for changes in activities allowed and cost principles.	_____	_____	_____	_____	_____
c. Computations are checked for accuracy.	_____	_____	_____	_____	_____
d. Supporting documentation is compared to list of allowable and unallowable expenditures.	_____	_____	_____	_____	_____
e. Adjustments to unallowable costs are made where appropriate and follow-up action is taken to determine the cause.	_____	_____	_____	_____	_____
f. There is adequate segregation of duties in review and authorization of costs.	_____	_____	_____	_____	_____
g. Accountability for authorization is fixed in an individual who is knowledgeable of the requirements for determining activities allowed and allowable costs.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. Reports, such as a comparison of budget to actual, are provided to appropriate management on a timely basis for review.	_____	_____	_____	_____	_____
b. The entity has established internal and external communication channels on activities and costs allowed.	_____	_____	_____	_____	_____
c. Training programs, both formal and informal, provide knowledge and skills necessary to determine activities and costs allowed.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
d. There is interaction between management and staff regarding questionable costs.	_____	_____	_____	_____	_____
e. Grant agreements (including program laws, regulations, handbooks, and so forth) and cost principles circulars are available to the staff responsible for determining activities allowed and allowable costs under federal awards.	_____	_____	_____	_____	_____
<b>6. Monitoring—</b>					
a. Management reviews supporting documentation of allowable cost information.	_____	_____	_____	_____	_____
b. There is flow of information from federal agency to appropriate management personnel.	_____	_____	_____	_____	_____
c. Budget to actual comparisons of allowable costs are made.	_____	_____	_____	_____	_____
d. Analytic reviews (such as, comparison of budget to actual or prior year to current year) and audits are performed.	_____	_____	_____	_____	_____
<b>C. Cash Management</b>					
1. <i>Control objectives</i> —To provide reasonable assurance that the draw down of federal cash is only for immediate needs, an entity that is a state complies with applicable Treasury agreements, and recipients limit payments to subrecipients to immediate cash needs.					
2. <i>Control Environment</i> —					
a. There are appropriate assignments of responsibility for approving cash draw downs and payments to subrecipients.	_____	_____	_____	_____	_____
b. Budgets for draw downs are consistent with realistic cash needs.	_____	_____	_____	_____	_____
3. <i>Risk Assessment</i> —					
a. Mechanisms exist to anticipate, identify, and react to routine events that affect cash needs.	_____	_____	_____	_____	_____
b. The entity routinely assesses the adequacy of subrecipient cash needs.	_____	_____	_____	_____	_____
c. Management has identified programs that receive cash advances and is aware of cash management requirements.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
4. Control Activities—					
a. Cash flow statements by program are prepared to determine essential cash flow needs.	_____	_____	_____	_____	_____
b. The accounting system is capable of scheduling payments for accounts payable and requests for funds from Treasury to avoid a time lapse between draw down of funds and actual disbursements of funds.	_____	_____	_____	_____	_____
c. There is an appropriate level of supervisory review of cash management activities.	_____	_____	_____	_____	_____
d. The entity has a written policy that provides—					
(1) Procedures for requesting cash advances as close as is administratively possible to actual cash outlays.	_____	_____	_____	_____	_____
(2) Monitoring of cash management activities.	_____	_____	_____	_____	_____
(3) Repayment of excess interest earnings where required.	_____	_____	_____	_____	_____
e. For state programs subject to a Treasury-State agreement, a written policy exists that includes—					
(1) Programs covered by the agreement.	_____	_____	_____	_____	_____
(2) Methods of funding to be used.	_____	_____	_____	_____	_____
(3) Method used to calculate interest.	_____	_____	_____	_____	_____
(4) Procedures for determining check clearing patterns (if applicable for the funding method).	_____	_____	_____	_____	_____
5. Information and Communication—					
a. The entity performs variance reporting of expected versus actual cash disbursements of federal awards and draw downs of federal funds.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. There is an established channel of communication between the entity and its subrecipients regarding cash needs.	_____	_____	_____	_____	_____
6. Monitoring—					
a. There are periodic independent evaluations (such as by internal audit or top management) of entity cash management, budget and actual results, repayment of excess interest earnings, and federal draw down activities.	_____	_____	_____	_____	_____
b. Subrecipients' requests for federal funds are evaluated for propriety.	_____	_____	_____	_____	_____
c. Compliance with Treasury-State agreements is reviewed.	_____	_____	_____	_____	_____
<b>D. Davis-Bacon Act</b>					
1. <i>Control objectives</i> —To provide reasonable assurance that contractors and subcontractors are paid prevailing wage rates for projects covered by the Davis-Bacon Act.					
2. <i>Control Environment</i> —					
a. Management understands and communicates to staff, contractors, and subcontractors the requirements to pay wages in accordance with the Davis-Bacon Act.	_____	_____	_____	_____	_____
b. Management understands its responsibility for monitoring compliance.	_____	_____	_____	_____	_____
3. <i>Risk Assessment</i> —					
a. Mechanisms are in place to identify contractors and subcontractors that are the most at risk of not paying the prevailing wage rates.	_____	_____	_____	_____	_____
b. Management has identified how compliance will be monitored and the related risks of failure to monitor for compliance with Davis-Bacon Act.	_____	_____	_____	_____	_____
4. <i>Control Activities</i> —					
a. Contractors are informed in the procurement documents of the requirements for prevailing wage rates.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. Contractors and subcontractors are required to submit certifications and copies of payrolls that meet the requirements to pay prevailing wage rates.	_____	_____	_____	_____	_____
c. Contractors' and subcontractors' payrolls are monitored for compliance with prevailing wage rates.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. Prevailing wage rates are appropriately communicated.	_____	_____	_____	_____	_____
b. Reports provide sufficient information to determine if requirements are being met.	_____	_____	_____	_____	_____
c. Channels are established for staff, contractors, and workers to report misclassifications or failure to pay prevailing wages.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Management performs reviews to ensure that contractors and subcontractors are being required to pay prevailing wage rates.	_____	_____	_____	_____	_____
b. On-site visits are performed to monitor classifications and wage rates.	_____	_____	_____	_____	_____
c. Monitoring reports from contractors are compared to independent checks.	_____	_____	_____	_____	_____

## E. Eligibility

1. *Control objectives*—To provide reasonable assurance that only eligible individuals and organizations receive assistance under federal award programs, that subawards are made only to eligible subrecipients, and that amounts provided to or on behalf of eligibles were calculated in accordance with program requirements.
2. *Control Environment*—
  - a. Staff size and competence provides for proper eligibility determinations. \_\_\_\_\_
  - b. The entity establishes realistic caseload/performance targets for eligibility determinations. \_\_\_\_\_

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
c. Lines of authority are clear for determining eligibility.	_____	_____	_____	_____	_____
3. Risk Assessment—					
a. The entity identifies the risk that eligibility information prepared internally or received from external sources could be incorrect.	_____	_____	_____	_____	_____
b. Conflict-of-interest statements are maintained for individuals who determine eligibility.	_____	_____	_____	_____	_____
c. There is a process for assessing risks resulting from changes to eligibility determination systems.	_____	_____	_____	_____	_____
4. Control Activities—					
a. Written policies provide direction for making and documenting eligibility determinations.	_____	_____	_____	_____	_____
b. The entity's procedures to calculate eligibility amounts are consistent with program requirements.	_____	_____	_____	_____	_____
c. Eligibility objectives and procedures are clearly communicated to employees.	_____	_____	_____	_____	_____
d. Authorized signatures (manual or electronic) on eligibility documents are periodically reviewed.	_____	_____	_____	_____	_____
e. Access to eligibility records is limited to appropriate persons.	_____	_____	_____	_____	_____
f. Manual criteria checklists or automated process are used in making eligibility determinations.	_____	_____	_____	_____	_____
g. There is a process for periodic eligibility redeterminations in accordance with program requirements.	_____	_____	_____	_____	_____
h. Information used in eligibility determinations is verified for accuracy.	_____	_____	_____	_____	_____
i. There are procedures to ensure that accurate and complete data are used to determine eligibility requirements.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
5. Information and Communication—					
a. The information system meets the needs of eligibility decision-makers and program management.	_____	_____	_____	_____	_____
b. The processing of eligibility information is subject to edit checks and balancing procedures.	_____	_____	_____	_____	_____
c. Training programs inform employees of eligibility requirements.	_____	_____	_____	_____	_____
d. Channels of communication exist for people to report suspected eligibility improprieties.	_____	_____	_____	_____	_____
e. Management is receptive to suggestions to strengthen the eligibility determination process.	_____	_____	_____	_____	_____
f. Program personnel document eligibility determinations in accordance with program requirements.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Management performs periodic analytical reviews of eligibility determinations.	_____	_____	_____	_____	_____
b. Program quality control procedures are performed.	_____	_____	_____	_____	_____
c. There are periodic audits of detailed transactions.	_____	_____	_____	_____	_____

**F. Equipment and Real Property Management**

1. *Control objectives*—To provide reasonable assurance that proper records are maintained for equipment acquired with federal awards, equipment is adequately safeguarded and maintained, disposition or encumbrance of any equipment or real property is in accordance with federal requirements, and the federal awarding agency is appropriately compensated for its share of any property sold or converted to non-federal use.
2. *Control Environment*—
  - a. Management is committed to providing proper stewardship for property acquired with federal awards. \_\_\_\_\_
  - b. No incentives exist to undervalue assets at time of disposition. \_\_\_\_\_
  - c. Sufficient accountability exists to discourage temptation of misuse of federal assets. \_\_\_\_\_

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
3. Risk Assessment—					
a. Procedures exist to identify the risk of misappropriation or improper disposition of property acquired with federal awards.	_____	_____	_____	_____	_____
b. Management understands requirements and operations sufficiently to identify potential areas of noncompliance (such as, decentralized locations, departments with budget constraints, transfers of assets between departments).	_____	_____	_____	_____	_____
4. Control Activities—					
a. Accurate records are maintained on all acquisitions and dispositions of property acquired with federal awards.	_____	_____	_____	_____	_____
b. Property tags are placed on equipment.	_____	_____	_____	_____	_____
c. A physical inventory of equipment is periodically taken and compared to property records.	_____	_____	_____	_____	_____
d. Property records contain descriptions, including serial number or other identification number, source, who holds title, acquisition date and cost, percentage of federal participation in the cost, location, condition, and disposition data.	_____	_____	_____	_____	_____
e. Procedures are established to ensure that the federal awarding agency is appropriately reimbursed for dispositions of property acquired with federal awards.	_____	_____	_____	_____	_____
f. Policies and procedures are in place for responsibilities of recordkeeping and authorities for disposition.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. The accounting system provides for separate identification of property acquired wholly or partly with federal funds and with non-federal funds.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. A channel of communication exists for people to report suspected improprieties in the use or disposition of equipment.	_____	_____	_____	_____	_____
c. Program managers are provided with applicable requirements and guidelines.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Management reviews the results of periodic inventories and follows up on inventory discrepancies.	_____	_____	_____	_____	_____
b. Management reviews dispositions of property to ensure appropriate valuation and reimbursement to federal awarding agencies.	_____	_____	_____	_____	_____

**G. Matching, Level of Effort, Earmarking**

1. <i>Control objectives</i> —To provide reasonable assurance that matching, level of effort, and earmarking requirements are met using only allowable funds or costs that are properly calculated and valued.					
2. <i>Control Environment</i> —					
a. There is a commitment from management to meet matching, level of effort, and earmarking requirements (such as, adequate budget resources to meet a specified matching requirement or maintain a required level of effort).	_____	_____	_____	_____	_____
b. The budgeting process addresses and provides adequate resources to meet matching, level of effort, or earmarking goals.	_____	_____	_____	_____	_____
c. An official written policy exists outlining—					
(1) Responsibilities for determining required amounts or limits for matching, level of effort, and earmarking.	_____	_____	_____	_____	_____
(2) Methods of valuing matching requirements, such as "in-kind" contributions of property and services, and calculations of levels of effort.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
(3) Allowable costs that may be claimed for matching, level of effort, and earmarking.	_____	_____	_____	_____	_____
(4) Methods of accounting for and documenting amounts used to calculate amounts claimed for matching, level of effort, and earmarking.	_____	_____	_____	_____	_____
3. Risk Assessment—					
a. The entity identifies areas where estimated values will be used for matching, level of effort, and earmarking.	_____	_____	_____	_____	_____
b. Management has sufficient understanding of the accounting system to identify potential recording problems.	_____	_____	_____	_____	_____
4. Control Activities—					
a. Evidence is obtained (such as a certification from the donor) or other procedures are performed to identify whether matching contributions—					
(1) Are from non-federal sources.	_____	_____	_____	_____	_____
(2) Involve federal funding, directly or indirectly.	_____	_____	_____	_____	_____
(3) Were used for another federally-assisted program. (Note: Generally, matching contributions must be from a non-federal source and may not involve federal funding or be used for another federally-assisted program.)	_____	_____	_____	_____	_____
b. There is adequate review of monthly cost reports and adjusting entries.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. The entity has an accounting system capable of—					
(1) Separately accounting for data used to support matching, level of effort, and earmarking amounts, limits, or calculations.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
(2) Ensuring that expenditures or expenses, refunds, and cash receipts or revenues are properly classified and recorded only once as to their effect on matching, level of effort, and earmarking.	_____	_____	_____	_____	_____
(3) Documenting the value of "in-kind" contributions of property or services, including—					
(i) Basis for local labor market rates for valuing volunteer services.	_____	_____	_____	_____	_____
(ii) Payroll records or confirmation from other organizations for services provided by their employees.	_____	_____	_____	_____	_____
(iii) Quotes, published prices, or independent appraisals used as the basis for donated equipment, supplies, land, buildings, or use of space.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Supervisory reviews of matching, level of effort, and earmarking activities are performed to assess the accuracy and allowability of transactions and determinations (such as, at the time reports on federal awards are prepared).	_____	_____	_____	_____	_____

#### H. Period of Availability of Federal Funds

1. *Control objectives*—To provide reasonable assurance that federal funds are used only during the authorized period of availability.
2. *Control Environment*—
  - a. Management understands and is committed to complying with period of availability requirements.
  - b. Entity's operations are such that it is unlikely there will be federal funds remaining at the end of the period of availability.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
3. Risk Assessment—					
a. The budgetary process considers period of availability of federal funds as to both obligation and disbursement.	_____	_____	_____	_____	_____
b. The entity identifies and communicates period of availability cut-off requirements as to both obligation and disbursement.	_____	_____	_____	_____	_____
4. Control Activities—					
a. The accounting system prevents obligation or expenditure of federal funds outside of the period of availability.	_____	_____	_____	_____	_____
b. A person knowledgeable of period of availability of funds requirement reviews disbursements.	_____	_____	_____	_____	_____
c. End of grant period cut-offs are met by such mechanisms as advising program managers of the impending cut-off dates and reviewing expenditures just before and after the cut-off date.	_____	_____	_____	_____	_____
d. The entity cancels unliquidated commitments at the end of the period of availability.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. Period of availability requirements and expenditure deadlines are timely communicated to individuals responsible for program expenditures, including through automated notifications of pending deadlines.	_____	_____	_____	_____	_____
b. Unliquidated balances are periodically reported to appropriate levels of management and followed up on.	_____	_____	_____	_____	_____
6. Monitoring—					
a. The entity periodically reviews expenditures before and after the cut-off date to ensure compliance with period of availability requirements.	_____	_____	_____	_____	_____
b. Management reviews reports showing budget and actual for the period.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
<b>I. Procurement and Suspension and Debarment</b>					
1. <i>Control objectives</i> —To provide reasonable assurance that procurement of goods and services are made in compliance with the provisions of the A-102 Common Rule or OMB Circular A-110, as applicable, and that no subaward, contract, or agreement for purchases of goods or services is made with any debarred or suspended party.					
2. <i>Control Environment</i> —					
a. Codes of conduct and other policies regarding acceptable practice, conflicts-of-interest, or expected standards of ethical and moral behavior for making procurements exist and are implemented.	_____	_____	_____	_____	_____
b. The entity has a procurement manual that incorporates federal requirements.	_____	_____	_____	_____	_____
c. There is an absence of pressure to meet unrealistic procurement performance targets.	_____	_____	_____	_____	_____
d. Management has a prohibition against intervention or overriding established procurement controls.	_____	_____	_____	_____	_____
e. Board or governing body oversight is required for high dollar, lengthy, or other sensitive procurement contracts.	_____	_____	_____	_____	_____
f. Key procurement managers have adequate knowledge and experience in light of their responsibilities for procurements for federal awards.	_____	_____	_____	_____	_____
g. There is a clear assignment of authority for issuing purchasing orders and contracting for goods and services.	_____	_____	_____	_____	_____
3. <i>Risk Assessment</i> —					
a. There are procedures to identify risks arising from vendor inadequacy, such as, quality of goods and services, delivery schedules, warranty assurances, and user support.	_____	_____	_____	_____	_____
b. The entity has established procedures to identify risks arising from conflicts-of-interest, such as kickbacks, related party transactions, and bribery.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
c. Management understands the requirements for procurement and suspension and debarment, and, given the entity's staff, departments, and processes, has identified where noncompliance could likely occur.	_____	_____	_____	_____	_____
d. Conflict-of-interest statements are maintained for individuals with responsibility for procurement of goods or services.	_____	_____	_____	_____	_____
4. Control Activities—					
a. There are job descriptions or other means of defining tasks that comprise particular procurement jobs.	_____	_____	_____	_____	_____
b. The entity monitors and documents contractors' performance with the terms, conditions, and specifications of the contracts.	_____	_____	_____	_____	_____
c. The entity segregates duties between employees responsible for contracting, accounts payable, and cash disbursing.	_____	_____	_____	_____	_____
d. Procurement actions are appropriately documented in the procurement files.	_____	_____	_____	_____	_____
e. Supervisors review procurement and contracting decisions for compliance with federal procurement policies.	_____	_____	_____	_____	_____
f. Procedures are established to verify that vendors providing goods and services under the award have not been suspended or debarred by the federal government.	_____	_____	_____	_____	_____
g. The entity has an official written policy for procurement and contracts establishing—					
(1) Contract files that document significant procurement history.	_____	_____	_____	_____	_____
(2) Methods of procurement that are authorized, including selection of contract type, contractor selection or rejection, and the basis of contract price.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
(3) Verification that procurements provide full and open competition.	_____	_____	_____	_____	_____
(4) Requirements for cost or price analysis, including for contract modifications.	_____	_____	_____	_____	_____
(5) Requirements to obtain and react to suspension and debarment certifications.	_____	_____	_____	_____	_____
(6) Other applicable requirements for procurements under federal awards.	_____	_____	_____	_____	_____
<i>h.</i> The entity has an official written policy for suspensions and debarments that—					
(1) Contains or references the federal requirements.	_____	_____	_____	_____	_____
(2) Prohibits the award of a subaward, covered contract, or any other covered agreement for program administration, goods, services, or any other program purpose with any suspended or debarred party.	_____	_____	_____	_____	_____
(3) Requires staff to obtain certifications from entities receiving subawards (contract and subcontract) over \$100,000 certifying that the recipient organization and its principals are not suspended or debarred.	_____	_____	_____	_____	_____
<b>5. Information and Communication—</b>					
<i>a.</i> The entity has a system in place to assure that procurement documentation is retained for the time period required by the A-102 Common Rule, OMB Circular A-110, award agreements, contracts, and program regulations and that such documentation includes—					
(1) The basis for contractor selection.	_____	_____	_____	_____	_____
(2) Justification for lack of competition when competitive bids or offers are not obtained.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree.</u>
(3) The basis for award cost or price.	_____	_____	_____	_____	_____
b. Employees' procurement duties and control responsibilities are effectively communicated.	_____	_____	_____	_____	_____
c. Channels of communication are provided for people to report suspected procurement and contracting improprieties.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Management periodically conducts independent reviews of procurements and contracting activities to determine whether policies and procedures are being followed as intended.	_____	_____	_____	_____	_____
<b>J. Program Income</b>					
1. <i>Control objectives</i> —To provide reasonable assurance that program income is correctly earned, recorded, and used in accordance with the program requirements.					
2. <i>Control Environment</i> —					
a. Management recognizes its responsibilities for program income.	_____	_____	_____	_____	_____
b. Management prohibits intervention or overriding controls over program income.	_____	_____	_____	_____	_____
c. There are realistic performance targets for the generation of program income.	_____	_____	_____	_____	_____
3. <i>Risk Assessment</i> —					
a. Mechanisms are in place to identify the risk of unrecorded or mis-coded program income.	_____	_____	_____	_____	_____
b. Variances between expected and actual income are analyzed.	_____	_____	_____	_____	_____
4. <i>Control Activities</i> —					
a. Pricing and collection policies procedures are clearly communicated to personnel responsible for program income.	_____	_____	_____	_____	_____
b. Mechanism are in place to ensure that program income is properly recorded as earned and deposited in the bank as collected.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
c. Policies and procedures provide for correct use of program income in accordance with federal program requirements.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. Information systems identify program income collections and usage.	_____	_____	_____	_____	_____
b. A channel of communication exists for people to report suspected improprieties in the collection or use of program income.	_____	_____	_____	_____	_____
6. Monitoring—					
a. There is an internal audit of program income.	_____	_____	_____	_____	_____
b. Management compares program income to budget and investigates significant differences.	_____	_____	_____	_____	_____

**K. Real Property Acquisition and Relocation Assistance**

1. <i>Control objectives</i> —To provide reasonable assurance of compliance with the real property acquisition, appraisal, negotiation, and relocation requirements.					
2. Control Environment—					
a. Management is committed to ensuring compliance with the Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, as amended (URA).	_____	_____	_____	_____	_____
b. Written policies exist for handling relocation assistance and real property acquisition.	_____	_____	_____	_____	_____
3. Risk Assessment—					
a. The entity identifies the risk that relocation will not be conducted in accordance with the URA (for example, that improper payments will be made to individuals or businesses that relocate).	_____	_____	_____	_____	_____
4. Control Activities—					
a. Employees handling relocation assistance and real property acquisition have been trained in the requirements of the URA.	_____	_____	_____	_____	_____



	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. Employees knowledgeable in the URA review expenditures pertaining to real property acquisition and relocation assistance.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. A system is in place to adequately document relocation assistance and real property acquisition.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Management monitors relocation assistance and real property acquisition for compliance with the URA.	_____	_____	_____	_____	_____

**L. Reporting**

1. <i>Control objectives</i> —To provide reasonable assurance that reports of federal awards submitted to the federal awarding agency or pass-through entity include all activity of the reporting period, are supported by underlying accounting or performance records, and are fairly presented in accordance with program requirements.					
2. Control Environment—					
a. Persons preparing, reviewing, and approving the reports possess the required knowledge, skills, and abilities.	_____	_____	_____	_____	_____
b. Management's attitude toward reporting promotes accurate and fair presentation.	_____	_____	_____	_____	_____
c. Management appropriately assigns responsibility and delegates authority for reporting decisions.	_____	_____	_____	_____	_____
3. Risk Management—					
a. Mechanisms exist to identify risks of faulty reporting caused by such items as lack of current knowledge of, inconsistent application of, or carelessness or disregard for standards and reporting requirements of federal awards.	_____	_____	_____	_____	_____
b. The entity identifies underlying source data or analyzes performance or special reporting that may not be reliable.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
4. Control Activities—					
a. A written policy exists that establishes responsibility and provides the procedures for periodic monitoring, verification, and reporting of program progress and accomplishments.	_____	_____	_____	_____	_____
b. There is a tracking system that reminds staff when reports are due.	_____	_____	_____	_____	_____
c. The general ledger or other reliable records are the basis for the reports.	_____	_____	_____	_____	_____
d. Supervisory review of reports are performed to ensure the accuracy and completeness of the data and information included in the reports.	_____	_____	_____	_____	_____
e. The required accounting method is used (for example, cash or accrual).	_____	_____	_____	_____	_____
5. Information and Communication—					
a. There is an accounting or information system that provides for the reliable processing of financial and performance information for federal awards.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Communications from external parties corroborate information included in the reports for federal awards.	_____	_____	_____	_____	_____
b. The entity periodically compares reports to supporting records.	_____	_____	_____	_____	_____

**M. Subrecipient Monitoring**

1. *Control objectives*—To provide reasonable assurance that federal award information and compliance requirements are identified to subrecipients, subrecipient activities are monitored, subrecipient audit findings are resolved, and the impact of any subrecipient noncompliance on the pass-through entity is evaluated. Also, the pass-through entity performs procedures to provide reasonable assurance that the subrecipient obtained required audits and takes appropriate corrective action on audit findings.
2. *Control Environment*—
  - a. Management establishes a “tone at the top” indicating its commitment to monitoring subrecipients.

\_\_\_\_\_

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. Management is intolerant of overriding established procedures to monitor subrecipients.	_____	_____	_____	_____	_____
c. The entity's organizational structure and its ability to provide the necessary information flow to monitor subrecipients are adequate.	_____	_____	_____	_____	_____
d. Sufficient resources are dedicated to subrecipient monitoring.	_____	_____	_____	_____	_____
e. The entity has defined the knowledge, skills, and abilities needed to accomplish subrecipient monitoring tasks.	_____	_____	_____	_____	_____
f. The individuals performing subrecipient monitoring possess the knowledge, skills, and abilities required.	_____	_____	_____	_____	_____
g. Subrecipients demonstrate that—					
(1) They are willing and able to comply with the requirements of the award.	_____	_____	_____	_____	_____
(2) They have accounting and internal control systems adequate to administer the award.	_____	_____	_____	_____	_____
(3) Their accounting systems include the use of applicable cost principles.	_____	_____	_____	_____	_____
h. Appropriate sanctions are taken for subrecipient noncompliance.	_____	_____	_____	_____	_____
3. Risk Assessment—					
a. Key managers understand the subrecipients' environments, systems, and controls sufficiently to identify the level and methods of monitoring required.	_____	_____	_____	_____	_____
b. The entity has evaluated the subrecipients' processes for addressing potential Year 2000 failures in their computer systems and equipment.	_____	_____	_____	_____	_____
c. Mechanisms exist to identify risks arising from external sources affecting subrecipients, such as risks related to—					

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
(1) Economic conditions.	_____	_____	_____	_____	_____
(2) Political conditions.	_____	_____	_____	_____	_____
(3) Regulatory changes.	_____	_____	_____	_____	_____
(4) Unreliable information.	_____	_____	_____	_____	_____
d. Mechanisms exist to identify and react to changes in subrecipients, such as—					
(1) Financial problems that could lead to diversion of grant funds.	_____	_____	_____	_____	_____
(2) Loss of essential personnel.	_____	_____	_____	_____	_____
(3) Loss of license or accreditation to operate program.	_____	_____	_____	_____	_____
(4) Rapid growth.	_____	_____	_____	_____	_____
(5) New activities, products, or services.	_____	_____	_____	_____	_____
(6) Organizational restructuring.	_____	_____	_____	_____	_____
4. Control Activities—					
a. The entity provides subrecipients with federal award information (such as, CFDA title and number, award name, name of federal agency, amount of award) and applicable compliance requirements.	_____	_____	_____	_____	_____
b. The entity includes in its subrecipient agreements the requirement to comply with the compliance requirements applicable to the federal program, including the audit requirements of OMB Circular A-133.	_____	_____	_____	_____	_____
c. The entity monitors the subrecipients' compliance with audit requirements using techniques such as the following—					
(1) The entity determines by inquiry and discussions whether subrecipients met thresholds requiring an audit under Circular A-133.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
(2) If an audit is required, the entity assures that the subrecipient submits the report, report package, or the documents required by OMB circulars or its own requirements.	_____	_____	_____	_____	_____
(3) If a subrecipient was required to obtain an audit in accordance with Circular A-133 but did not do so, the entity follows up with the subrecipient until the audit is completed and takes appropriate actions such as withholding further funding until the subrecipient meets the audit requirements.	_____	_____	_____	_____	_____
d. The entity monitors subrecipients' compliance with federal program requirements by, for example—					
(1) Issuing timely management decisions for audit and monitoring findings to inform the subrecipient whether the corrective action planned is acceptable.	_____	_____	_____	_____	_____
(2) Maintaining a system to track and follow up on reported deficiencies related to programs funded by the entity and to ensure that timely corrective action is taken.	_____	_____	_____	_____	_____
(3) Regularly contacting subrecipients and making appropriate inquiries concerning the federal program.	_____	_____	_____	_____	_____
(4) Reviewing subrecipient reports and follows up on areas of concern.	_____	_____	_____	_____	_____
(5) Monitoring subrecipient budgets.	_____	_____	_____	_____	_____
(6) Performing site visits to subrecipients to review financial and programmatic records and to observe operations.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
(7) Offering subrecipients technical assistance where needed.	_____	_____	_____	_____	_____
e. Official written policies exist requiring or establishing—					
(1) The communication of federal award requirements to subrecipients.	_____	_____	_____	_____	_____
(2) The monitoring of subrecipients.	_____	_____	_____	_____	_____
(3) Processes and procedures for monitoring subrecipients.	_____	_____	_____	_____	_____
(4) A methodology for resolving findings of subrecipient noncompliance or internal control weaknesses.	_____	_____	_____	_____	_____
(5) Subrecipient audits and their processing, including appropriate adjustment of pass-through entity's accounts.	_____	_____	_____	_____	_____
5. Information and Communication—					
a. Standard award documents used by the entity contain—					
(1) A listing of federal requirements that the subrecipient must follow, either as part of the award document, attached as an exhibit to the document, or incorporated by reference to specific criteria.	_____	_____	_____	_____	_____
(2) The description and program number for each program as stated in the CFDA. If the program funds include pass-through funds from another recipient, the pass-through program information also should be identified.	_____	_____	_____	_____	_____
(3) A statement signed by an official of the subrecipient stating that the subrecipient was informed of, understands, and agrees to comply with the applicable compliance requirements.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. A recordkeeping system is in place to assure that documentation is retained for the time period required by the federal agency.	_____	_____	_____	_____	_____
c. Procedures are in place to provide channels for subrecipients to communicate concerns to the entity.	_____	_____	_____	_____	_____
6. Monitoring—					
a. The entity has established a tracking system to assure timely submission of required reporting (such as financial reports, performance reports, and audit reports), on-site monitoring reviews of subrecipients, and timely resolution of audit findings.	_____	_____	_____	_____	_____
b. Supervisory reviews are performed to determine the adequacy of subrecipient monitoring.	_____	_____	_____	_____	_____

**N. Special Tests and Provisions**

The specific requirement for special tests and provisions are unique to each federal program and are found in the laws, regulations, and the provisions of contracts or grant agreements pertaining to each program. Therefore, standardized internal control objectives and examples of characteristics specific to this type of compliance requirement cannot be provided.

[The next page is 12,101.]





# AAM Section 12,100

## *Designing the Audit Program*

.01 The objective of an audit is to express an opinion on whether financial statements present fairly in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.<sup>1</sup> 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—

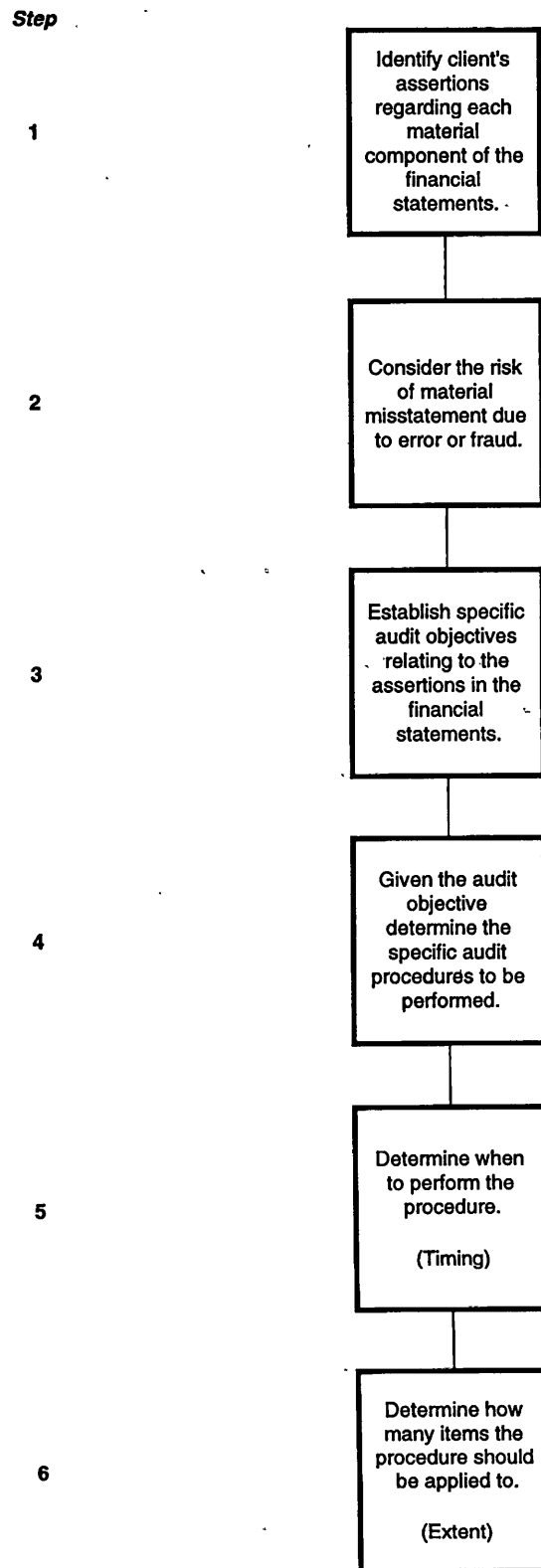
- a. Identify the client's assertions regarding each material component of the financial statements.
- b. Consider the risk of material misstatement due to error or fraud.
- c. Establish specific audit objectives relating to the assertions in the financial statements.
- d. Determine the audit procedures to be performed to accomplish the audit objectives.
- e. Determine when to perform the audit procedures.
- f. Determine which 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.

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<sup>1</sup> This section does not specifically address considerations necessary to design programs for audits conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States or Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (single audits). For such considerations, the auditor is advised to see chapters 4 and 5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (With Conforming Changes as of May 1, 1998)*, AICPA Statement of Position 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, and the AICPA Practice Aid, *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations."*

**Flowchart 1**  
**Audit Logic Process**



## 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:

- 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. An example of the relationship between financial statement assertions and audit objectives is shown in Figure 1.

Figure 1

### Relationship of Assertions and Objectives for Inventory

<u>Financial Statement Assertion</u>	<u>Illustrative Audit Objectives</u>
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.
Rights 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.

## 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 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 entity 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.

**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
- 

**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.

.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.

## 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 (AU section 326):

- 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.

.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 entities, satisfying the completeness objective can be difficult for the auditor in a small entity 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 326.25), 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 the auditor must express a qualified opinion or a disclaimer of opinion.

.39 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor*, as amended by SAS No. 82 (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 (AU section 326), 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 questioning the lack of specific types of transactions.

.41 Practitioners sometimes accept management representations as sufficient audit evidence when completeness of recorded transactions cannot be substantiated. Management 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 management 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 management have been received, there is a limitation on the scope of the audit that precludes the auditor from issuing an unqualified opinion (SAS No. 85, *Management Representations*, paragraph 14 [AU section 333.14]).

## 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 entities often lack segregation of duties, which usually prevents the auditor from assessing control risk at a low level. As a result, it is necessary to perform substantive tests of the completeness assertion.

## Substantive Tests

.44 Many substantive tests are of limited usefulness in detecting errors of omission because they are usually applied to recorded amounts. Unrecorded transactions are not included in the account balances or classes of transactions to which the auditor applies substantive tests.

.45 Of all the financial statement assertions, only completeness involves consideration of whether there are material amounts that are not included in the account balance or class of transactions being tested. Therefore, substantive tests of the completeness assertion differ somewhat from substantive tests of other financial statement assertions. The difference is highlighted by the following excerpt from SAS No. 31, paragraph 11, as amended (AU section 326.11):

In designing substantive tests to achieve an objective related to the assertion of existence or occurrence, the auditor selects from items contained in a financial statement amount and searches for relevant evidential matter. On the other hand, in designing procedures to achieve an objective related to the assertion of completeness, the auditor selects from evidential matter indicating that an item should be included in the relevant financial statement amount and investigates whether that item is so included.

.46 Substantive tests can be designed to provide evidential matter to support a conclusion that specific account balances are not misstated by amounts that would cause the financial statements, taken as a whole, to be materially misstated because of unrecorded transactions.

.47 Important sources of evidential matter for completeness include source documents, such as order logs, shipping and receiving documents, and checks. One common test of completeness involves tracing amounts from source documents to amounts recorded in the accounting records. For example, the auditor may vouch selected cash disbursements after the end of the audit period to test the completeness of amounts recorded as accounts payable at the balance-sheet date. Other substantive procedures that provide evidence concerning the completeness of financial statement account balances include the following:

- a. Sales-and-purchases cutoff procedures that include tracing shipping and receiving documents processed after the audit period to accounting records for the proper period.
- b. Analytical procedures in which the auditor investigates relationships among data that indicate a financial statement account or balance may be understated. For example, the auditor may obtain evidence that all interest-bearing debt is recorded by examining the relationship between recorded

interest expense and the average balance of interest-bearing debt outstanding for the period. Disproportionate relationships based on the auditor's knowledge of interest rates should be investigated. Other examples include: a comparison of investment income to average investments for the period to test whether income earned on investments is recorded; the relationship of average pay times number of employees to payroll expense to substantiate that salaries are recorded; and the relationship of membership fee revenue to the number of members of an organization.

- c. Confirmations of balances or transactions designed to identify unrecorded amounts, such as accounts payable confirmations that request the creditor to specify the amount of the client's obligation.
  - d. Tests of bank reconciliations, including examination of checks clearing the bank after the audit period to identify cash disbursements processed but not recorded or inappropriately recorded in the subsequent period.
  - e. Reading the minutes of the meetings (of the) board of directors and stockholders and tracing transactions authorized in the minutes to amounts recorded in the accounting records.
  - f. Overall reconciliations using financial and nonfinancial data, such as "proofs" of cash and sales.
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*[The next page is 12,201.]*



# AAM Section 12,200

## *Illustrative Audit Programs for State and Local Governmental Units*

The material included in this section relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>I. Engagement Planning and Administration<sup>1</sup></b>			
<b>A. Engagement Planning Procedures</b>			
1. Determine whether a signed engagement letter proposal or contract covering the current engagement is on file. Read the letter/contract for any special provisions.	_____	_____	_____
2. Determine whether the engagement letter/contract establishes an understanding with the entity regarding the services to be performed for the engagement, including that:			
a. The objective of the audit is the expression of an opinion on the financial statements.	_____	_____	_____
b. Management is responsible for the entity's financial statements.	_____	_____	_____
c. Management is responsible for establishing and maintaining effective internal control over financial reporting.	_____	_____	_____
d. Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.	_____	_____	_____

<sup>1</sup> This program only addressed issues related to an audit of financial statements in accordance with generally accepted auditing standards (GAAS). It does not address issues related to single audits in accordance with the provisions of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* or financial statements audits in accordance with the provisions of *Government Auditing Standards* issued by the Comptroller General of the United States (the "Yellow Book"). For single audits, see AAM section 12,200.150. For Yellow Book audits other than those performed in conjunction with a single audit, see chapters 4 and 5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (With Conforming Changes as of May 1, 1998)*. This audit program also does not address compliance audits of state, local, or nongovernmental grants. See the AICPA's Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (AUD section 11,320), paragraphs 3.47 through 3.49 for a brief discussion of some the considerations in auditing such grants.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
e. Management is responsible for making all financial records and related information available to the auditor.	_____	_____	_____
f. At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.	_____	_____	_____
g. The auditor is responsible for conducting the audit in accordance with generally accepted auditing standards, which require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements.	_____	_____	_____
h. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.	_____	_____	_____
i. An audit includes obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify reportable conditions. However, the auditor is responsible for ensuring that the audit committee or others with equivalent authority or responsibility are aware of any reportable conditions that come to his or her attention.	_____	_____	_____
3. Review the suggested reference materials in AAM section 12,210 that are relevant to the scope of the engagement.	_____	_____	_____
4. If this is a new client:			
a. Perform procedures to determine the integrity of management, including inquiries of local attorneys, bankers, and other business leaders as to the entity's standing in the community and a check of the entity's credit rating.	_____	_____	_____
b. Determine whether the required communications in SAS No. 84, <i>Communications Between Predecessor and Successor Auditors</i> [AU section 315] have been made.	_____	_____	_____
c. Request the entity to communicate with the predecessor auditor authorizing that auditor to respond to our inquiries and to allow our firm to review prior year working papers.	_____	_____	_____
d. If the predecessor auditor provides an acknowledgment letter, determine whether our firm has signed and returned it, and file a copy in the working papers.	_____	_____	_____
e. Prepare a list of prior year working papers needed for review and communicate the list to the predecessor auditor.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
f. Make arrangements for review of prior year working papers.	_____	_____	_____
g. Document the results of the review of prior year working papers.	_____	_____	_____
5. Determine whether the decision to accept the engagement (in case of new client) or to retain the client has been documented. (See AAM section 11,200.11.)	_____	_____	_____
6. Determine the type of financial statements to be audited (comprehensive annual financial report, general purpose financial statements, and so forth) and the due dates of the auditor's reports.	_____	_____	_____
7. Determine the type of audit services to be provided—such as, a financial statement audit, an audit in accordance with <i>Government Auditing Standards</i> , an OMB Circular A-133 audit, or a compliance audit of state, local, or nongovernmental grants. <sup>2</sup>	_____	_____	_____
8. Determine whether all applicable independence rules, particularly those related to performance of accounting and other nonaudit services and to component units, have been met for the firm and the audit team.	_____	_____	_____
9. Review accounts receivable from the entity to determine whether any outstanding amounts take on some of the characteristics of loans and may, therefore, impair the firm's independence.	_____	_____	_____
10. Determine the extent of involvement of other auditors and inquire about their independence and professional reputation. Clearly define the responsibilities of each audit firm and which firm is the primary auditor.	_____	_____	_____
11. Obtain a knowledge of matters affecting the governmental environment, including			
a. Economic conditions and developments.	_____	_____	_____
b. Regulatory and legislative conditions and developments.	_____	_____	_____
c. Changes in technology.	_____	_____	_____
d. Accounting principles and practices for governmental entities.	_____	_____	_____
12. Obtain an initial, overall understanding of the entity's operations:			
a. Determine the form of government, for example, a legislative body with an elected administrator (such as a mayor) 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 function.	_____	_____	_____

<sup>2</sup> See footnote 1.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
c. Obtain a list of all related parties.	_____	_____	_____
d. Inquire of management about its policies relative to the prevention of illegal acts and assess its identification of laws, statutes, regulations, and contracts governing the general operations of the entity.	_____	_____	_____
e. Determine whether the entity 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 entity, for example, the presence or absence of taxpayer initiatives that limit the taxing authority's growth, expenditure growth, or the addition of services.	_____	_____	_____
g. Determine annually which legally separate entities are to be included in the financial statements as component units of the reporting entity as well as how the units are to be presented (discrete or blended).	_____	_____	_____
h. Determine whether the audit covered by the signed engagement letter will satisfy relevant legal, regulatory, and contractual requirements.	_____	_____	_____
i. If audit does not satisfy <i>h.</i> above, communicate this to management, the audit committee (or other with equivalent authority, such as the City Council or other elected officials) either in writing or orally. If orally, document in the working papers.	_____	_____	_____
13. Based on a review the prior year reports, financial statements, and working papers, the permanent file, interim financial statements for the current period, and discussions with appropriate entity personnel:			
a. Identify primary sources of revenue (for example, property taxes, grants, contracts, and service charges).	_____	_____	_____
b. Identify services provided by the entity.	_____	_____	_____
c. Identify services provided by separate governmental departments and component units (for example, hospitals, schools) and their relationship to the entity to be audited.	_____	_____	_____
d. Determine the number and nature of funds and account groups.	_____	_____	_____
e. Determine the entity's significant accounting policies and procedures.	_____	_____	_____
f. Determine whether any departures from generally accepted accounting principles were identified in the prior audit that could lead to report modifications in the current audit.	_____	_____	_____
14. Review the prior year working papers and the permanent file, particularly the following:			
a. Internal control questionnaires, memoranda, and related summary evaluation notes.	_____	_____	_____
b. Engagement time summary records.	_____	_____	_____



	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
c. Adjusting and reclassification entries.	_____	_____	_____
d. Memoranda regarding consultations on accounting and auditing matters.	_____	_____	_____
e. Suggestions for the next audit.	_____	_____	_____
f. The entity's correspondence file.	_____	_____	_____
15. If the entity 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 [AU section 322])	_____	_____	_____
16. Obtain copies of minutes of meetings of the governing body and relevant committees and review for items of significance.	_____	_____	_____
17. Obtain a copy (including all amendments) of the entity's current budget (for all funds legally budgeted).	_____	_____	_____
18. Obtain all documents and information required for the permanent file and remove superseded materials for filing in a closed file.	_____	_____	_____
19. Discuss the following (and other appropriate) matters with appropriate entity personnel:			
a. Changes in operations, including pending/planned changes.	_____	_____	_____
b. Debt issued or refunded during the auditor period.	_____	_____	_____
c. Changes in accounting methods or accounting principles applied.	_____	_____	_____
d. Changes in key personnel, particularly those who can influence financial reporting.	_____	_____	_____
e. Principal findings of internal auditors.	_____	_____	_____
f. Personnel compensation and benefit policies.	_____	_____	_____
g. Significant accounting or reporting problems.	_____	_____	_____
h. The various locations at which the entity conducts business and provides services.	_____	_____	_____
i. Changes in information technology methods or technology.	_____	_____	_____
j. The entity's year 2000 compliance issues and its disclosure obligations relating to those issues. <sup>3</sup>	_____	_____	_____

<sup>3</sup> The Securities and Exchange Commission (SEC) and the Governmental Accounting Standards Board (GASB) have issued guidance relating to disclosure of year 2000 issues—see AAM section 12,210. On October 22, 1998, the Audit Issues Task Force of the AICPA issued a notice advising auditors to be very cautious about being associated with the disclosures required by GASB *Technical Bulletin 98-1, Disclosures about Year 2000 Issues*, because sufficient audit evidence may not exist to support the required disclosures. The notice includes illustrative report language and is available on the AICPA Web site and fax hotline. (See also the AICPA's publication, *The Year 2000 Issue: Current Accounting and Auditing Guidance* [October 19, 1998], which is available on the AICPA Web site, and the Auditing Interpretations concerning year 2000 issues at AU sections 9311 and 9341.)

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
k. The nature and amount of the entity's related party transactions that require disclosure in the financial statements.	_____	_____	_____
l. Significant legal matters and contingencies; including environmental remediation liabilities.	_____	_____	_____
m. Known violations of legal and contractual provisions.	_____	_____	_____
n. Debt covenants and any known violations of them.	_____	_____	_____
o. Disposition of prior year management letter points, reportable conditions, and findings and questioned costs.	_____	_____	_____
p. Closing information to be prepared, such as closing journal entries and post-closing trial balance.	_____	_____	_____
q. Assistance to be provided by entity personnel.	_____	_____	_____
r. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work, and so forth.	_____	_____	_____
s. Adequacy of working space for the audit team.	_____	_____	_____
t. Access to entity records, including the entity's working hours and holidays and vacations scheduled by key personnel.	_____	_____	_____
u. The effect of new accounting and auditing pronouncements on the entity.	_____	_____	_____
v. Other matters (prepare list and attach to program).	_____	_____	_____
20. Consider the effect of the entity's information technology systems on the audit.	_____	_____	_____
21. Obtain from management a listing of the laws and regulations that have a direct and material effect on the financial statements for the working papers and obtain an understanding of the effects of such laws and regulations.	_____	_____	_____
22. Consider the presence of fraud risk factors in the following categories: <sup>4</sup>			
a. Management characteristics and influence over the control environment.	_____	_____	_____
b. Industry conditions.	_____	_____	_____
c. Operating characteristics and financial stability.	_____	_____	_____
d. Susceptibility of assets to misappropriation.	_____	_____	_____
e. Controls over the misappropriation of assets.	_____	_____	_____
23. Inquire of management about:			
a. Its understanding regarding the risk of fraud in the entity.	_____	_____	_____
b. The knowledge it may have of fraud that has been perpetrated on or within the entity.	_____	_____	_____

<sup>4</sup> See the AICPA's Practice Aid, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*. The Practice Aid includes industry-specific example risk factors for governmental entities.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
c. 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.	_____	_____	_____
24. Assess the risk of material misstatement due to fraud.	_____	_____	_____
25. For identified fraud risk factors, develop an appropriate audit response.	_____	_____	_____
26. Document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud.	_____	_____	_____
27. Obtain an understanding of the entity'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 entity'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) 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. (See SAS No. 80 [AU section 326].)	_____	_____	_____
(3) For each assertion for which a lowering of control risk below the maximum is deemed feasible and efficient:			
(a) Identify specific control relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions and that 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 who applied them. 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
(c) Document conclusions in the working papers concerning the assessed level of control risk for the assertion.	_____	_____	_____
28. Obtain preliminary financial information from the entity for the period under audit.	_____	_____	_____
a. Compute planning materiality at the appropriate level (general purpose financial statements, individual fund, and so forth).	_____	_____	_____
b. Perform analytical procedures to identify unusual or unexpected transactions, amounts, ratios, or trends that might have planning ramifications. Compare recorded amounts with:			
(1) Prior year amounts, adjusted for known changes from the prior year to the current year.	_____	_____	_____
(2) Budgeted amounts.	_____	_____	_____
(3) Other financial and nonfinancial information for which plausible relationships exist.	_____	_____	_____
c. 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.	_____	_____	_____
29. Consider factors influencing the risk of errors, fraud, or illegal acts causing financial statements to be materially misstated by evaluating the following:			
a. The existence of laws, rules, and regulations that may have a direct and material effect on amounts reported in the financial statements.	_____	_____	_____
b. Unusual or unexpected transactions, events, amounts, ratios, or trends noted as a result of analytical procedures.	_____	_____	_____
c. The existence of material accounting estimates.	_____	_____	_____
d. The existence of many contentious or difficult accounting issues.	_____	_____	_____
e. Recent accounting/auditing pronouncements affecting the client.	_____	_____	_____
f. The existence of significant difficult-to-audit transactions.	_____	_____	_____
g. The appearance of an unduly aggressive attitude on the part of management towards financial reporting.	_____	_____	_____
h. Management's and elected officials' poor reputation in the governmental community.	_____	_____	_____
i. The circumstance that the entity is a new client and sufficient prior audit information is not available from the predecessor auditor.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
j. The potential for management misrepresentation.	_____	_____	_____
k. The susceptibility of assets to unauthorized use or disposition.	_____	_____	_____
l. The ability of the entity to operate within approved budgets and to issue timely and accurate financial reports.	_____	_____	_____
m. The appropriate segregation of duties and responsibilities.	_____	_____	_____
n. The dependence of the entity on one or more individuals to operate key programs or manage the budget or financial reporting functions.	_____	_____	_____
o. The effectiveness of the internal audit function.	_____	_____	_____
p. Turnover and qualifications of key personnel.	_____	_____	_____
q. Qualifications in auditors' reports for prior years.	_____	_____	_____
r. The ability of key subsidiary accounting systems to produce data needed to support the financial statements.	_____	_____	_____
s. 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.	_____	_____	_____
30. Use the information obtained or developed concerning materiality levels, fraud risk factors, controls over financial reporting and compliance with laws and regulations and the related assessments of control risk, the results of analytical procedures, the entity's use of electronic information systems, and the evaluation of other factors affecting audit risk to:			
a. Plan the nature, timing, and extent of substantive tests.	_____	_____	_____
b. Determine engagement timing, staffing requirements, and related levels of supervision. (In scheduling engagement personnel, consider the engagement size and complexity, personnel knowledge and skills, personnel availability given the timing of the engagement, special expertise required, continuity and periodic rotation of personnel, and opportunities for on-the-job training.	_____	_____	_____
c. Determine whether the use of specialists (such as actuaries or information technology specialists) will be required for the audit.	_____	_____	_____
d. Plan the overall strategy for the conduct and scope of audit.	_____	_____	_____
e. Prepare/revise the audit programs, incorporating considerations of financial statement assertions, specific audit objectives, and appropriate audit procedures to achieve the specific objectives.	_____	_____	_____
31. Prepare an audit planning memorandum for review and approval by the audit partner that includes:			
a. Audit approach.	_____	_____	_____
b. Use of analytical procedures.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
c. Documentation of internal control.	_____	_____	_____
d. Approach used to audit computer generated records.	_____	_____	_____
e. Use of statistical sampling methods.	_____	_____	_____
f. Assessment of audit risk and materiality.	_____	_____	_____
g. Audit programs.	_____	_____	_____
h. Time budget, estimated completion date, and staffing of engagement, including responsibilities and supervision.	_____	_____	_____
i. Use of specialists.	_____	_____	_____
32. Discuss the audit plan with the engagement personnel. Have them review the planning memorandum.	_____	_____	_____
33. Schedule timing of work to be done on priority basis, assigning top priorities to more significant or problem areas of engagement.	_____	_____	_____
34. Prepare a listing of schedules/analyses to be prepared by the entity (and working paper set-ups, if considered necessary) and deliver to the entity. Perform the following on all schedules/analyses received (these steps can be performed during substantive testing):			
a. Vouch amounts to the general ledger.	_____	_____	_____
b. Reperform the footings and crossfootings (test basis may be appropriate).	_____	_____	_____
c. Trace opening balances to final balances in the prior year working papers.	_____	_____	_____
d. Determine whether the working papers are marked "Prepared by Client" or "PBC".	_____	_____	_____
<b>B. Engagement Administration and Supervision Procedures<sup>5</sup></b>			
1. Accumulate all points concerning internal control related matters to be communicated to the entity (SAS No. 60, as amended by SAS No. 78 [AU section 325]).	_____	_____	_____
a. Review the listing with the engagement partner and determine which points are to be included in written communications and which points are to be communicated verbally to the entity.	_____	_____	_____
b. For those items to be communicated verbally to the entity, document the communication.	_____	_____	_____
c. For all other items, prepare the written communication.	_____	_____	_____
2. Determine whether all steps in all audit programs have been considered and/or completed, and whether any modifications to the programs resulting from changed conditions have been properly approved and documented.	_____	_____	_____

<sup>5</sup> See also the Financial Reporting Audit Program at AAM section 12,200.140.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
3. If statistical or nonstatistical sampling was used for substantive tests of details, determine whether (SAS No. 39, paragraphs 15 through 30 [AU section 350.15-.30]):			
a. Consideration was 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. The sample was selected in such a way that it could be expected to be representative of the population.	_____	_____	_____
c. The misstatement results of the sample were projected to the items from which the sample was selected.	_____	_____	_____
d. Consideration was given, in evaluating the sample, to items for which the planned substantive tests or appropriate alternate procedures could not be performed.	_____	_____	_____
e. Consideration was 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. The documentation of the foregoing considerations was in accordance with firm policy.	_____	_____	_____
4. Determine whether all working papers have been headed, indexed, cross-referenced, initialed, and dated.	_____	_____	_____
5. Clear all pending items, and dispose of all follow-up or "TO DO" sheets and any other similar notations in the files.	_____	_____	_____
6. Review financial statements and notes and:			
a. Determine the adequacy of evidence gathered in response to unusual or unexpected balances or transactions identified during audit planning or audit performance.	_____	_____	_____
b. Determine the existence of unusual or unexpected balances or relationships that have not been evaluated.	_____	_____	_____
c. Determine 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.	_____	_____	_____
7. Determine whether 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.	_____	_____	_____
8. Determine whether 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
9. 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 presented in the auditor's report.	_____	_____	_____
10. If audit tests identify significant misstatements in the financial statements, consider whether such misstatements may be indicative of fraud.	_____	_____	_____
11. 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.	_____	_____	_____
12. 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].)	_____	_____	_____
13. Determine whether required communications, proper as to form and content, have been made to disclose fraud and/or illegal acts noted during the course of the audit.	_____	_____	_____
14. 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.	_____	_____	_____
15. If a substantial doubt exists with regard to 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 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.	_____	_____	_____
16. If the entity 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 whether the following matters have been communicated and include documentation to that effect in the working papers (SAS No. 61 [AU section 380]):			
a. The auditors' responsibility under generally accepted auditing standards.	_____	_____	_____



	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Initial selection of and changes in significant accounting policies or their application.	_____	_____	_____
c. The process used by management in formulating particularly sensitive accounting estimates and the basis for the auditors' conclusions regarding the reasonableness of those estimates.	_____	_____	_____
d. 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.	_____	_____	_____
e. The auditor's responsibility for other information in documents containing audited financial statements (such as a comprehensive annual financial report).	_____	_____	_____
f. Disagreements with management.	_____	_____	_____
g. Consultations by management with other accountants about auditing and accounting matters.	_____	_____	_____
h. Major issues discussed with management prior to retention.	_____	_____	_____
i. Difficulties encountered in performing the audit.	_____	_____	_____
j. If this communication is in writing, determine whether it includes restricted use language as provided by SAS No. 87.	_____	_____	_____
17. Determine whether 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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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  
ByDateW/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 the general fund 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. At a minimum, the budgetary amounts shown in the financial statements (1) include the general fund and all other governmental funds of the primary government for which annual budgets have been adopted and (2) present the initially adopted budget and all legally approved amendments thereto at no higher a level than revenue source and expenditure program or function. (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) have been adequately disclosed in the financial statements, including whether they constitute violations of laws or regulations. (Assertions 2 and 5)
- E. Budgetary amounts shown in the financial statements are shown on the budgetary basis of accounting and reconciled to the GAAP basis of accounting, if different. (Assertions 4 and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>A. Audit Procedures to Test Budgetary Information</b>				
[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.	_____	_____	_____
C D	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 approval of the 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 include all approved amendments.	_____	_____	_____
<b>B. Audit Procedures to Test Budgetary Compliance and Reporting</b>				
D	1. Determine whether the monitoring process for budgetary controls leads to amendments to the budget as dictated by changing circumstances and laws and regulations.	_____	_____	_____
E	2. Vouch the entity's budgetary report to its accounting records on a test basis.	_____	_____	_____
D	3. 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.	_____	_____	_____
C	4. Determine whether, at a minimum, the budgetary presentation in the financial statements (a) includes the general fund and all other governmental funds of the primary government for which annual budgets have been adopted and (b) presents the initially adopted budget and all legally approved amendments thereto at no higher a level than revenue source and expenditure program or function.	_____	_____	_____
E	5. If applicable, review the reconciliation of budgetary basis to GAAP basis and determine that it has been adequately disclosed in the financial statements.	_____	_____	_____

Obj.

Done  
By      Date      W/P  
                                 Ref.

C. Overall Conclusions

- 1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:
  - a. An annual budget has been adopted for the general fund and, if required by law, for other funds of the entity.
  - b. All amendments to the initially adopted budget have been properly approved.
  - c. At a minimum, the budgetary amounts shown in the financial statements (1) include the general fund and all other governmental funds of the primary government for which annual budgets have been adopted and (2) present the initially adopted budget and all legally approved amendments thereto at no higher a level than revenue source and expenditure program or function.
  - 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, including whether they constitute violations of laws or regulations.
  - e. Budgetary amounts shown in the financial statements are shown on the budgetary basis of accounting and reconciled to the GAAP basis of accounting, if different.

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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  
ByDateW/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 reported in the financial statements properly represent cash and cash items on hand, in transit, or on deposit with third parties. (Assertions 1, 2, and 3)
- 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. (Assertions 2, 3, and 5)
- C. Cash deposits are made in accordance with legal and contractual provisions. (Assertions 2 and 5)
- D. Financial statement presentation and disclosure of cash are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 3, 4, and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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**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.


<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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>B. Analytical Procedures</b>			
	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.	_____	_____	_____
	<b>C. Other Auditing Procedures</b>			
A	1. Where material, count cash on hand, reconcile balances on hand to recorded amounts, and obtain signature of custodian acknowledging return of funds intact.	_____	_____	_____
A	2. Confirm balances of depository accounts with banks or other depositories as of the balance-sheet date using the <i>AICPA Standard Form to Confirm Account Balance Information With Financial Institutions</i> [see AAM section 7200.04].	_____	_____	_____
[A]	3. Obtain copies of the entity'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 that did not clear 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A	6. Consider reversing old outstanding checks. (Investigate those over \$_____.) Determine whether such amounts have been handled properly in accordance with state or local escheat laws.	_____	_____	_____
[A]	7. Review receipts and disbursements shortly before and shortly after year-end to determine whether all cash collected and paid has been recorded in the proper period.	_____	_____	_____
C	8. Examine legal and contractual provisions for restrictions on the use of depository accounts (such as a requirement to use in-state depositories) and review the entity's compliance with such restrictions.	_____	_____	_____
	9. Obtain copies of all collateral agreements the entity has with depositories:			
C	a. Confirm collateral with bank or agent holding the collateral securities.	_____	_____	_____
C	b. Determine whether the collateral complies with legal requirements for the entity.	_____	_____	_____
C	c. Determine whether the pledging procedures surrounding and the fair value of the collateral is adequate to secure the funds on deposit and to meet legal requirements.	_____	_____	_____
C D	d. Test collateralization throughout the year to determine its adequacy. Note instances in which the entity's uncollateralized deposits during the period significantly exceeded that category of credit risk at balance-sheet date.	_____	_____	_____
C D	e. Review the entity's classification of deposits as to credit risk for note disclosure, including the amount of deposits covered by depository insurance.	_____	_____	_____
C	10. Identify which (if any) individual funds are required by legal or contractual provisions to maintain separate bank accounts and ascertain that separate bank accounts are maintained.	_____	_____	_____
B	11. Note any withdrawal restrictions or other commitments that may exist on cash and review financial statement presentation or note disclosure regarding significant restrictions or other commitments.	_____	_____	_____
B C D	12. If the entity 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 the entity has conformed to GAAP in its reporting and note disclosure of the allocation of earnings on pooled cash to individual funds.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	e. Determine whether overdrafts by individual funds and of bank accounts in total have been reported in accordance with GAAP.	_____	_____	_____
B D	13. Determine whether investments that are classified as cash equivalents conform to the entity's policy for such classification and whether the classification is consistent with the prior-year's classification. <sup>1</sup>	_____	_____	_____
<b>D. Overall Conclusions</b>				
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Cash balances reported in the financial statements properly represent cash and cash items on hand, in transit, or on deposit with third parties.	_____	_____	_____
	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. Cash deposits are made in accordance with legal and contractual provisions.	_____	_____	_____
	d. Financial statement presentation and disclosure of cash are in conformity with GAAP consistently applied.	_____	_____	_____
	Except as follows:			
	_____			
	_____			
	_____			

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

Date

Done by

Reviewed by

<sup>1</sup> Additional questions concerning the investments that are reported in the balance sheet as cash equivalents are included in AAM section 12,200.040.



The material included in this section relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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  
ByDateW/P  
Ref.**IV. Investments and Investment Income<sup>1</sup>****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 properly represent investments owned by the entity (or held by it for others in a fiduciary capacity) and held either on hand or in custody and safekeeping by others on behalf of the entity. (Assertions 1, 2, and 3)
- B. Investments are properly classified in the financial statements and adequate disclosure (by segregation or otherwise) is made of restricted or pledged investments. (Assertions 2, 3, and 5)
- C. Investments are made in accordance with legal and contractual provisions. (Assertions 2 and 5)
- D. Financial statement presentation and disclosure of investments and the related income are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 3, 4, and 5)
- E. Reverse repurchase agreement and securities lending transactions are properly accounted for and reported. (Assertions 1, 2, 3, 4, and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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<sup>1</sup> This section does not specifically address investments held by external investment pools that are sponsored by governmental entities; see GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This section also does not address investments held by pension trust funds; see AAM section 12,200.135.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>A. Evaluation of Internal Control</b>			
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>B. Analytical Procedures</b>			
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.	_____	_____	_____
<b>C. Other Auditing Procedures</b>			
[C] 1. Obtain an understanding of legal and contractual provisions governing the investment of idle funds.	_____	_____	_____
[A] [B] [D] 2. Obtain a listing of investments and accrued investment income that identifies ownership by fund and that shows:			
a. The reported value and fair value of investments by type and the reported value of accrued investment income at the beginning and end of the period.	_____	_____	_____
b. Investment additions, sales, and other dispositions, holding gains and losses, the amortization of discounts and premiums, and investment income received and accrued during the period.	_____	_____	_____
c. Descriptions of the investments, including the interest rates, unamortized discounts or premiums, and maturity dates of debt securities, the numbers of shares and par values of equity securities, and so forth.	_____	_____	_____
[A] [B] [D] 3. Foot and crossfoot the listing.	_____	_____	_____
[A] [B] [D] 4. Trace beginning and ending totals to the prior period audit working papers and general ledger, respectively.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A [B] [D]	5. For securities held on hand:			
	a. On a test basis, examine securities and trace applicable information from the security to the 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 [B] [D]	6. For securities held by others, confirm information pertaining to securities held by them, including the name in which security is registered or held.	_____	_____	_____
A [B] [D]	7. For investments other than securities—such as investments in external investment pools and open ended mutual funds, joint ventures, and venture capital—examine appropriate evidence of the entity's ownership and confirm with the issuer.	_____	_____	_____
A [B] [D]	8. For unsettled investment transactions, confirm with the broker-dealer.	_____	_____	_____
A [B] [D]	9. Consider the need to confirm settled and unsettled investment transactions with the counterparty.	_____	_____	_____
D	10. Determine the entity's policies for the valuation of its various investments, whether those policies are in accordance with generally accepted accounting principles, and whether those policies are appropriately applied to the various investments in its portfolio.	_____	_____	_____
D	11. For investments reported at fair value, determine on a test basis that recorded values represent fair values by performing the following:			
	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 that 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 entity 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. 70, <i>Reports on the Processing of Transactions by Service Organizations</i> , or SAS No. 73, <i>Using the Work of a Specialist</i> .	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	e. For investments valued by the entity 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.	_____	_____	_____
D	12. For investments reported using cost-based measures:			
	a. Obtain evidence about the cost of those investments, through inspection and/or confirmation.	_____	_____	_____
	b. Investigate significant differences between fair values and reported values as well as management's intended holding period and liquidity requirements to determine whether any write-downs are necessary.	_____	_____	_____
D	13. For investments in joint ventures in which the entity has an equity interest, determine whether the entity has measured and reported its investment in accordance with the provisions of GASB Statement No. 14, <i>The Financial Reporting Entity</i> .	_____	_____	_____
D	14. Determine whether the changes in fair value of those investments that are reported using fair value are appropriately recognized and reported in the statement of operations.	_____	_____	_____
D	15. Test investment income (interest, dividends, and so forth) received and accrued to the balance-sheet date.	_____	_____	_____
D	16. For investments that are reported using cost-based measures, test the amortization of purchased premiums or discounts through recomputation.	_____	_____	_____
C	17. Test investment transactions during the year to determine whether investments comply with the entity's legal and contractual provisions.			
	a. If approval of investment transactions are required by legal and contractual provisions, review the minutes of meeting of the governing body or investment committee for that approval.	_____	_____	_____
	b. Review for unusual transactions.	_____	_____	_____
D	18. Verify that all investments and related income were applied to the proper funds.	_____	_____	_____
C D	19. If the entity pools investments on an internal basis:			
	a. Determine whether pooling of funds for investment purposes is permissible under the entity's legal and contractual provisions.	_____	_____	_____
	b. Obtain records from entity personnel allocating earnings on pooled investments to the individual funds.	_____	_____	_____
	c. Review the allocation of earnings for reasonableness, and test the accuracy of allocations, compliance with legal or contractual provisions or management policy.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	d. Review the allocation of earnings for compliance with legal or contractual provisions or management policy, and for proper financial reporting (that is, as direct revenue into the recipient fund or as an operating transfer).	_____	_____	_____
D	20. Review whether the entity's disclosures about investments conform to the provisions of GASB Statement No. 31.	_____	_____	_____
[C] D	21. Review the disclosures the entity makes to comply with GASB Statement No. 3, <i>Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements</i> , for the following:			
	a. The types of investments authorized by legal or contractual provisions.	_____	_____	_____
	b. Significant violations of legal or contractual provisions governing the investment of funds.	_____	_____	_____
	c. The types of investments made during the year but not owned as of the balance-sheet date.	_____	_____	_____
	d. The categories of credit risk for all investment securities. (Note that investment positions that are not represented by securities, such as positions in state investment pools and open-ended mutual funds, are disclosed but not classified.)	_____	_____	_____
	e. Credit risk for individual component units or funds that is not apparent because of the aggregation of the disclosure.	_____	_____	_____
	f. The fact of and causes for significantly higher category 3 credit risk positions during the period.	_____	_____	_____
	g. Unrealized investment losses for individual component units or funds that are not apparent because of the aggregation of the disclosure.	_____	_____	_____
	h. Losses recognized during the period due to default by counterparties to investment transactions and amounts recovered from prior-period losses if not separately displayed on the operating statement.	_____	_____	_____
	i. Commitments at the balance-sheet date to resell securities under yield maintenance repurchase agreements.	_____	_____	_____
[C] D	22. Concerning repurchase agreements:			
	a. Determine whether such transactions are allowable under the entity's legal and contractual provisions.	_____	_____	_____
	b. Review the terms of outstanding repurchase commitments, including the types and coupon rate of collateral and the repurchase date and prices.	_____	_____	_____
	c. Consider the reputation and reliability of collateral holders. Determine whether those holders are banks or trust companies that specialize in providing safekeeping services and that are independent of the broker-dealer arranging the transaction.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	d. Examine securities held or request confirmation of securities held in safekeeping and determine who holds legal title to the securities.	_____	_____	_____
	e. Test collateral value of securities.	_____	_____	_____
	f. Review the reputation and financial position of broker-dealers or other counterparties to the transaction.	_____	_____	_____
	g. Consider the financial credibility and legal responsibility of any company or agency that is insuring completion of the transaction.	_____	_____	_____
	h. Review broker's advices and other documentation regarding the completion of the repurchase transaction during the period following the balance-sheet date.	_____	_____	_____
B	23. Determine whether restrictions on investments have been properly disclosed in the financial statements or notes thereto.	_____	_____	_____
D	24. Determine whether long-term investments reported in governmental funds are appropriately offset by a fund balance reserve.	_____	_____	_____
D	25. If derivatives or similar investments were owned during the period, determine whether the entity's disclosures are in accordance with GASB Technical Bulletin 94-1, <i>Disclosures about Derivatives and Similar Debt and Investment Transactions</i> .	_____	_____	_____
E	26. Determine whether the entity's accounting and reporting for reverse repurchase agreement transactions is in accordance with GASB Statement No. 3 and GASB Interpretation No. 3, <i>Financial Reporting for Reverse Repurchase Agreements</i> .	_____	_____	_____
E	27. Determine whether the entity's accounting and reporting for securities lending transactions is in accordance with GASB Statement No. 28, <i>Accounting and Financial Reporting for Securities Lending Transactions</i> .	_____	_____	_____
<b>D. Overall Conclusions</b>				
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Investments reported in the financial statements properly represent investments owned by the entity (or held by it for others in a fiduciary capacity) and held either on hand or in custody and safekeeping by others on behalf of the entity.	_____	_____	_____
	b. Investments are properly classified in the financial statements and adequate disclosure (by segregation or otherwise) is made of restricted or pledged investments.	_____	_____	_____
	c. Investments are made in accordance with legal and contractual provisions.	_____	_____	_____
	d. Financial statement presentation and disclosure of investments and the related income are in conformity with GAAP consistently applied.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
e. Reverse repurchase agreement and 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 _____		_____	

The material included in this section relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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## 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. Revenues reported in the financial statements represent valid transactions and include all transactions that relate to the period. (Assertions 1 and 2)
- B. Receivables reported in the financial statements are valid, complete, and stated at the net realizable amount. (Assertions 1, 2, 3, and 4)
- C. Revenue transactions are in accordance with legal and contractual provisions. (Assertions 2 and 5)
- D. Financial statement presentation and disclosure of receivables and revenue are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 3, 4, and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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### A. Evaluation of Internal Control

1. Review the understanding of internal control over receivable and revenue transactions and the preliminary assessment of control risk.



<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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>B. Analytical Procedures</b>			
1. Review the planning procedures applicable to analytical procedures performed on receivables and revenue 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.	_____	_____	_____
<b>C. Other Auditing Procedures—Receivables and Revenues—Governmental Funds</b>			
<b>1. General</b>			
[A] [B] [D] a. Obtain or prepare a schedule of governmental fund receivables and revenue, showing opening balances, transactions during the period, and ending balances. Foot and crossfoot and agree to the prior-year working papers and the entity's general ledger.	_____	_____	_____
<b>2. General Property Taxes</b>			
[A] [C] a. Review the computation of total assessed value for property.	_____	_____	_____
[A] [C] [D] b. Compare the current year's assessed value to that of the prior year and obtain explanations for significant changes.	_____	_____	_____
A C c. Determine whether the appropriate tax was properly levied.	_____	_____	_____
(1) Determine whether property assessments have been made in compliance with laws.	_____	_____	_____
(2) Determine whether property tax rates are in compliance with laws.	_____	_____	_____
A B d. Recalculate the total tax levy and compare to the recorded revenue and receivables.	_____	_____	_____
A B D e. Recalculate tax levies for individual funds and compare to revenue and receivables recorded in each fund.	_____	_____	_____
D f. Review the entity's policy for recognizing property tax revenue to determine whether it conforms to generally accepted accounting principles.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A D	g. Test property tax receipts to determine whether the amounts recognized as revenue were levied to finance the current or a prior fiscal year, due to be paid on or before the balance-sheet date <sup>1</sup> and received during the fiscal year or the entity's "availability" period.	_____	_____	_____
A B C	h. 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	_____	_____	_____
A B D	i. Review allowance for uncollectible taxes for reasonableness and compare to prior year's computation. Obtain explanation for any unusual changes.	_____	_____	_____
A D	j. Determine whether deferred revenue accounts have been recorded in accordance with generally accepted accounting principles.	_____	_____	_____
A [B]	k. Determine whether property tax sales were properly authorized for nonpayment of taxes and the major receipts were deposited on a timely basis.	_____	_____	_____
D	l. Determine whether property tax policies and procedures are properly disclosed in the notes to financial statements.	_____	_____	_____
	m. Consider confirming property tax receivables where the entity does its own billing and collection procedures.	_____	_____	_____
<b>3. Sales Taxes</b>				
A B	a. Review the methods used by the entity 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, and so forth).	_____	_____	_____
A D	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 D	c. Review the entity's policy for recognizing sales tax revenue to determine whether it conforms to generally accepted accounting principles.	_____	_____	_____
A D	d. Test sales tax receipts to determine whether the amounts recognized as revenue relate to sales made during the current or a prior fiscal year and were received during the fiscal year or the entity's subsequent "availability" period.	_____	_____	_____

<sup>1</sup> If the entity has implemented the provisions of GASB Interpretation No. 5, *Property Tax Revenue Recognition in Governmental Funds*, the "due date" criterion does not apply. That Interpretation is effective for financial statements for periods beginning after June 15, 2000, with earlier application encouraged.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B D	e. Determine whether proper accruals have been made for sales taxes held by other governments at fiscal year end.	_____	_____	_____
	(1) Confirm taxes collected but not yet remitted directly with the collecting government.	_____	_____	_____
	(2) Trace amounts accrued to subsequent receipts.	_____	_____	_____
A B D	f. For sales taxes collected by merchants but not yet required to be remitted to the entity or its collecting government at the end of the fiscal year:			
	(1) Review methods used by the entity to estimate the amount of such sales tax collections.	_____	_____	_____
	(2) Compare current year accrual with prior year accrual.	_____	_____	_____
	(3) Determine whether proper consideration has been given to merchants' compensation and uncollectible taxes.	_____	_____	_____
	(4) Compare collections in the subsequent period to amounts estimated at year end and explain any unusual differences.	_____	_____	_____
A B C	g. 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.	_____	_____	_____
<b>4. Income and Other Self Assessed Taxes</b>				
A B	a. Review the methods used by the entity 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, and so forth).	_____	_____	_____
A D	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 D	c. Review the entity's policy for recognizing income and other self-assessed tax revenue to determine whether it conforms to generally accepted accounting principles.	_____	_____	_____
A D	d. Test tax receipts to determine whether the amounts recognized as revenue relate to taxable events and transactions that took place during the current or a prior fiscal year and were received during the fiscal year or the entity's subsequent "availability" period.	_____	_____	_____
A B D	e. Determine whether proper accruals have been made for income and other self-assessed taxes held by other governments at fiscal year end.	_____	_____	_____
	(1) Confirm taxes collected but not yet remitted directly with the collecting government.	_____	_____	_____
	(2) Trace amounts accrued to subsequent receipts.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B D	f. For income and other self-assessed taxes not yet required to be remitted to the entity or its collecting government at the end of the fiscal year:			
	(1) Review methods used by the entity to estimate the amount of such tax collections.	_____	_____	_____
	(2) Compare current year accruals with prior year accruals.	_____	_____	_____
	(3) Determine whether proper consideration has been given to uncollectible taxes and estimated refunds.	_____	_____	_____
	(4) Compare collections in the subsequent period to amounts estimated at year end and explain any unusual differences.	_____	_____	_____
A B C	g. 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.	_____	_____	_____
<b>5. Revenue From Federal, State, and County Agencies</b>				
A C	a. Review grant applications, agreements, contracts, budgets, and reports to determine whether grant expenditures are in accordance with grant agreements.	_____	_____	_____
A C	b. Review the reasonableness of the entity's indirect cost allocation plan and determine the propriety of indirect cost items allocated to grant programs.	_____	_____	_____
A C D	c. Review grant records and correspondence files for material areas of noncompliance and questioned costs.	_____	_____	_____
A C	d. For grant programs requiring matching funds, review supporting documentation to support the entity's contribution and determine allowability of any in-kind (goods or services) matching efforts.	_____	_____	_____
A C	e. For grant programs that generate program income, determine whether that income has been appropriately accounted for and classified in accordance with the program requirements.	_____	_____	_____
A D	f. Review the entity's policy for recognizing grant revenue to determine whether it conforms to generally accepted accounting principles.	_____	_____	_____
A D	g. Test grant revenue to determine whether amounts recognized conform to the entity's revenue recognition policy.	_____	_____	_____
A D	h. Confirm revenue received from federal, state, and county agencies and any revenue earned but not yet remitted directly with the appropriate agency.	_____	_____	_____
A D	i. Determine whether pass-through grants are properly accounted for.	_____	_____	_____
D	j. Determine whether amounts due from other governments are properly classified in the balance sheet and disclosed in the notes to financial statements.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>6. Licenses and Permits</b>				
[A] [C]	a. Determine licenses and permits in effect and rates set by laws and regulations.	_____	_____	_____
A D	b. Compare revenue from licenses and permits by totals to current year's budget and prior year actual revenue. Explain any unusual fluctuations or variations.	_____	_____	_____
A C	c. If licenses and permits constitute a material source of revenue:			
	(1) On a test basis, trace collections from persons or businesses ordinarily required to pay fees to accounting records.	_____	_____	_____
	(2) On a test basis, recompute the amounts of licenses and permits to determine whether fees are being assessed in accordance with laws and regulations.	_____	_____	_____
	(3) Where appropriate, reconcile usage of inventories of licenses and permits to revenues.	_____	_____	_____
<b>7. Franchise Fees</b>				
A C	a. Review franchise laws and regulations and compare fees as indicated therein with amounts received.	_____	_____	_____
A D	b. Compare revenue from franchise fees by totals to current year's budget and prior year actual revenue. Explain any unusual fluctuations or variations.	_____	_____	_____
D	c. Review the entity's policy for recognizing franchise fee revenue to determine whether it conforms to generally accepted accounting principles.	_____	_____	_____
A D	d. For major franchise fees, determine whether all fees for the fiscal year have been properly recognized.	_____	_____	_____
A B	e. Consider confirming franchise fees received or receivable during the year directly with the franchisee.	_____	_____	_____
<b>8. Fines</b>				
[A] C	a. Review and test the entity's procedures for accounting for tickets, and determine whether tickets are being properly disposed of through the collection of cash or authorized dismissal.	_____	_____	_____
A D	b. Compare fine revenue by totals to current year's budget and prior year actual revenue. Explain any unusual fluctuations or variations.	_____	_____	_____
A C	c. Determine whether fines are distributed in accordance with governing regulations.	_____	_____	_____
<b>9. Sale of Property and Equipment</b>				
[A] C	a. Review minutes of the governing board 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B C D	b. Determine whether proceeds are credited to the proper fund as required by law and that any receivables are properly classified.	_____	_____	_____
	c. Determine whether dispositions have been removed from the property and equipment records.	_____	_____	_____
<b>10. Rentals of Property and Equipment</b>				
[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 B D	c. Trace billings to recording in proper fund in the accounting records.	_____	_____	_____
A B D	d. Test for classification (such as, operating, sales, and direct financing type) as well as proper accounting for leases.	_____	_____	_____
<b>11. Special Assessments</b>				
[A] C	a. Examine minutes of the governing body for authorization of special assessments.	_____	_____	_____
[A] [D]	b. Review the entity's policy for recognizing special assessment revenue to determine whether it conforms to generally accepted accounting principles.	_____	_____	_____
	c. Obtain a schedule of assessment installments.	_____	_____	_____
A	(1) Compare current and past-due installment receipts to revenue recorded for current year.	_____	_____	_____
A B	(2) Compare total installment receivables to deferred revenue amounts.	_____	_____	_____
A D	d. Test assessments receipts to determine whether the amounts recognized as revenue are current or past-due installments and were received during the fiscal year or the entity's subsequent "availability" period.	_____	_____	_____
A B D	e. Review allowance for uncollectible special assessments for reasonableness and compare to prior year's computation. Obtain explanation for any unusual changes.	_____	_____	_____
A C	f. Using the interest rate stated in the assessment ordinance, recompute interest revenue for the current fiscal year and compare to recorded amounts.	_____	_____	_____
B	g. Obtain a list of all assessments receivable balances and compare the total of these balances to the general ledger control accounts.	_____	_____	_____
B	h. Consider confirming unpaid assessment balances directly with property owners, especially significant or old balances.	_____	_____	_____
A B	i. Review all adjustments to the accounts for authority and propriety.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	<b>12. Other Revenues</b>			
A B	a. Schedule any other revenue accounts of material amount			
C D	and perform audit procedures determined necessary.			
	<b>D. Other Auditing Procedures—Receivables—Governmental Funds</b>			
	<b>1. All Receivables</b>			
	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.			
	(3) The 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.			
	<b>2. Other Receivables</b>			
B	a. Obtain an aged listing of accounts receivable not examined in the preceding audit procedures. Test accuracy of listing and reconcile the balance with the general ledger.			
B	b. Confirm individual accounts with large or unusual balances directly with the owing party.			
A B	c. Obtain or list subsequent collections of past due items to date of field work.			
A B C	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.			
B	e. Review collectibility of accounts with responsible personnel and determine whether a proper allowance is established for uncollectible accounts.			
	<b>E. Overall Conclusions</b>			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Revenues reported in the financial statements represent valid transactions and include all transactions that relate to the period.			
	b. Receivables reported in the financial statements are valid, complete, and are stated at the net realizable value.			
	c. Revenue transactions are in accordance with legal and contractual provisions. (Assertions 2 and 5)			

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
d. Financial statement presentation and disclosure of receivables and revenue are in conformity with GAAP 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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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  
ByDateW/P  
Ref.**VI. Expenditures, Expenses, Payables, and Prepaid Items<sup>1</sup>****Financial Statement Assertions**

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

**Audit Objectives**

- A. Expenditures/expenses reported in the financial statements represent valid transactions and include all items that are applicable to the period. (Assertions 1 and 2)
- B. Payables and accrued liabilities reported in the financial statements are properly authorized, represent the correct amounts of currently payable items, and reflect all outstanding obligations. (Assertions 1, 2, 3, and 4)
- C. Prepaid items reported in the financial statements are valid, complete, and stated at the proper amount. (Assertions 1, 2, 3, and 4)
- D. Encumbrances and other commitments are identified and recorded or disclosed. (Assertions 2, 3, and 5)
- E. Expenditures/expenses are made in accordance with legal and contractual provisions. (Assertions 2 and 5)
- F. Financial statement presentation and disclosure of expenditures, expenses, payables, and prepaid items are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

<sup>1</sup> See also the audit program at AAM section 12,200.120 concerning risk financing and insurance related activities.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	<b>A. Evaluation of Internal Control</b>			
	1. Review the understanding of internal control over expenditures/expenses, payables, and prepaid items 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>B. Analytical Procedures</b>			
	1. Review the planning procedures applicable to analytical procedures performed on expenditures/expenses, payables, and prepaid items 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.	_____	_____	_____
	<b>C. Other Auditing Procedures</b>			
	<b>1. Expenditures/Expenses in General</b>			
[E]	a. Review the applicable laws and regulations setting forth the entity's procedures for making purchases.	_____	_____	_____
A C E	b. For selected expenditures/expenses (except those addressed in detail later in this audit program) examine supporting documents and compare to disbursement records noting:			
	(1) Authorization for disbursement and approval of supporting documents.	_____	_____	_____
	(2) Data supporting invoices such as purchase orders and receiving reports.	_____	_____	_____
	(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 documents.	_____	_____	_____
	(6) Evidence of duplicate payment, in whole or in part.	_____	_____	_____
	(7) Charge to proper expenditure/expense and appropriation accounts or reserve for encumbrances.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(8) That discounts were taken when offered.	_____	_____	_____
	(9) The check was signed by an authorized person.	_____	_____	_____
	(10) That the expenditure/expense was recorded in the period the goods or services were received (except for those items that are capitalized, for example, as prepaid items).	_____	_____	_____
	(11) Whether, for expenditures/expenses charged to grant programs, the costs were allowable and otherwise complied with program requirements (such as whether the charges were incurred during the grant period). <sup>2</sup>	_____	_____	_____
A E	c. Determine whether expenditures/expenses incurred by or on behalf of key officials are reasonable and adhere to the entity's policies.	_____	_____	_____
A F	d. Determine whether the entity properly accounts for expenditures/expenses for pass-through grants.	_____	_____	_____
A F	e. Schedule any other expenditure/expense accounts of material amount or unusual nature and perform audit procedures determined necessary.	_____	_____	_____
F	f. Determine whether on-behalf payments that the entity has made for salaries and fringe benefits for the employees of other entities have been classified as it classifies similar cash grants to such entities.	_____	_____	_____
A F	g. Compare individual expenditure/expense accounts to current year's budget and prior year's actual. Explain any unusual fluctuations or variations.	_____	_____	_____
	<b>2. Liabilities in General</b>			
B	a. Accounts Payable:			
	(1) Obtain a schedule of accounts payable outstanding at the end of the audit period.	_____	_____	_____
	(2) Reconcile the detail of liabilities to the general ledger amounts.	_____	_____	_____
	(3) Consider confirming large or unusual accounts payable balances.	_____	_____	_____
	(4) For selected entries in accounts payable (those in excess of \$_____), examine underlying documentation for proper support and proper inclusion in the period being audited.	_____	_____	_____
	(5) 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 the period being audited.	_____	_____	_____

<sup>2</sup> This step is not necessary for federal grant expenditures/expenses if the auditor is conducting an audit in accordance with the provisions of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, concurrently with the financial statement audit and the scope of that A-133 audit is sufficient to provide reasonable assurance concerning the entity's compliance with grant requirements that have a direct and material effect on financial statement amounts.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	<b>b. Deposit Liabilities:</b>			
B F	(1) If deposit liabilities are not material to the financial statements, review liability for reasonableness and explain any unusual variations from prior years. Otherwise—	_____	_____	_____
B	(2) Obtain listing of deposits (with indication of purpose of deposit if not otherwise noted) and reconcile to general ledger.	_____	_____	_____
B	(3) Confirm balances on a test basis.	_____	_____	_____
	(4) If interest is paid—			
A B E	(a) Examine documentation authorizing payment of interest and determine whether proper rate is being paid/accrued.	_____	_____	_____
A B	(b) Test interest payments made during the period and accrued as of the end of the audit period.	_____	_____	_____
E	(5) Review any related legal provisions and test for compliance.	_____	_____	_____
B	(6) Determine whether records of "bid" or "good faith" deposits are maintained, including records indicating disposition of such deposits.	_____	_____	_____
	<b>c. Taxes Levied or Collected for Other Governments:</b>			
B	(1) Obtain a schedule of collections, payments, and balances on hand that are due other governments and vouch to supporting documents on a test basis.	_____	_____	_____
B F	(2) Determine whether balances on hand are recorded as liabilities due to other governments.	_____	_____	_____
B	(3) Trace material amounts to settlements in subsequent period.	_____	_____	_____
	<b>d. Taxes Collected Under Protest:</b>			
B F	(1) Obtain listing of taxes collected under protest and reconcile to amounts recorded as such liabilities in the general ledger.	_____	_____	_____
B	(2) Trace large or unusual amounts to supporting documents.	_____	_____	_____
B	(3) Evaluate the entity's process for recognizing as revenue any portion of taxes collected under protest.	_____	_____	_____
B	(4) Trace disposition of items recorded as liabilities at the beginning of the audit period.	_____	_____	_____
	<b>e. Escheat Liabilities:</b>			
B F	(1) Obtain listing of escheat liabilities and reconcile to amounts recorded as such liabilities in the general ledger.	_____	_____	_____
B	(2) Evaluate the entity's process for recognizing escheat property as liabilities or revenue.	_____	_____	_____
B	(3) Trace disposition of items recorded as liabilities at the beginning of the audit period.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>3. Payroll and Payroll Taxes</b>				
	<i>a.</i> For selected payroll disbursements:			
A E	(1) Compare the rate of pay used in computing payroll disbursements with the employees' personnel files and with the salary and appropriation ordinances or other established pay scales.	_____	_____	_____
A	(2) Examine appropriate attendance records for the disbursements being examined.	_____	_____	_____
A	(3) Recompute gross pay and compare to amount computed by the entity.	_____	_____	_____
[A] B	(4) When applicable, verify that appropriate entries were made to the entity's leave records.	_____	_____	_____
A E	(5) For payroll charges made to grant programs, determine whether the costs were allowable and otherwise complied with program requirements (such as that appropriate time and attendance records were maintained). <sup>3</sup>	_____	_____	_____
A F	(6) Determine whether the payroll disbursements were charged to the proper appropriation accounts and funds.	_____	_____	_____
	<i>b.</i> For selected payroll tax payments:			
A	(1) Examine the entity's calculation of payroll taxes for propriety.	_____	_____	_____
A F	(2) Determine whether the payroll tax payments were charged to the proper appropriation accounts and funds.	_____	_____	_____
E	(3) If payroll tax payments were charged to grant programs, determine whether the costs were allowable and otherwise complied with program requirements. <sup>4</sup>	_____	_____	_____
B E	<i>c.</i> 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 F	<i>d.</i> Compare payroll and payroll tax accounts to budgeted amounts and to prior year's actual. Explain any unusual variations or fluctuations.	_____	_____	_____
A B E	<i>e.</i> Inquire 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.	_____	_____	_____

<sup>3</sup> See footnote 2.<sup>4</sup> See footnote 2.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B	f. From a comparison of pay periods and salary payment dates, determine whether an accrual should be made at year end for payroll and payroll taxes. If so, obtain a copy of the entity's worksheets for accruals of payroll and payroll taxes and test for accuracy.	_____	_____	_____
A F	g. Determine whether on-behalf payments made by other entities for salaries for the entity's employees have been accounted for and disclosed in accordance with GASB Statement No. 24, <i>Accounting and Financial Reporting for Certain Grants and Other Financial Assistance</i> .	_____	_____	_____
<b>4. Employee Fringe Benefits</b>				
[A]	a. Obtain the entity's personnel policies and procedures and review the provisions relating to employee fringe benefits.	_____	_____	_____
A B	b. For employee medical insurance payments, determine by appropriate tests that: <sup>5</sup>			
	(1) Payments are only made for eligible employees, including new employees only after the appropriate waiting period.	_____	_____	_____
	(2) An appropriate accrual has been made at year-end for payments owed but not yet made.	_____	_____	_____
	(3) Charges were made to the proper expenditure/expense and appropriation accounts and funds.	_____	_____	_____
	(4) Any payment refunds were appropriately credited to the proper expenditure/expense and appropriation accounts and funds.	_____	_____	_____
A B F	c. For compensated absences, obtain the entity's computation of its liability 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 pay or salary rates are applied.	_____	_____	_____
	(4) Leave balances shown on the schedule are reasonable and are consistent with leave records of selected employees.	_____	_____	_____
	(5) The entity has accrued an additional amount as a liability for salary-related payments associated with the payment of compensated absences, using the rates in effect at the balance sheet date.	_____	_____	_____
	(6) The schedule is correct as to the employing fund.	_____	_____	_____
	(7) The current and long-term portions of the liability have been recorded in accordance with GASB Statement No. 16, <i>Accounting for Compensated Absences</i> .	_____	_____	_____

<sup>5</sup> If the entity "self-insures" employee medical benefits, the audit program at AAM section 12,200.120 applies.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	d. For each sole or agent employer defined benefit pension plan, obtain a copy of the entity's actuarial valuation and a schedule of its annual required contribution, annual contribution, annual pension cost, and net pension obligation (NPO) by fund. <sup>6</sup>	_____	_____	_____
A B C F	(1) Determine by appropriate tests that:			
	(a) The schedule is arithmetically correct.	_____	_____	_____
	(b) The information in the schedule is consistent with the actuarial valuation.	_____	_____	_____
	(c) Annual contributions reconcile to actual disbursements.	_____	_____	_____
	(d) Annual pension cost and the NPO have been calculated in conformity with the requirements of GASB Statement No. 27, <i>Accounting for Pensions by State and Local Governmental Employers</i> .	_____	_____	_____
	(e) The details of the schedule reconcile to general ledger amounts.	_____	_____	_____
	(f) Amounts have been accounted for in the proper fund or account group.	_____	_____	_____
	(g) Amounts recognized as pension expenditures/expenses, liabilities, and assets are in conformity with generally accepted accounting principles.	_____	_____	_____
	(h) Disclosures in the notes to financial statements, required supplementary information, and notes to the required supplementary information are in conformity with generally accepted accounting principles.	_____	_____	_____
A B C	(2) For the actuarial valuation:			
	(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: <sup>7</sup>			
	(i) Whether the actuarial valuation considers all pertinent provisions of the plan, including any changes to the plan or other events affecting the actuarial calculations.	_____	_____	_____

<sup>6</sup> If the pension plan is reported as a pension trust fund in the entity's financial statements, these procedures should be coordinated with the procedures for the plan in AAM section 12,200.135.

<sup>7</sup> See the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix N, "Illustrative Request to Actuary for Confirmation of GASB Pension Information."

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(ii) Relationships between the actuary and the plan or the entity that may impair the actuary's objectivity.	_____	_____	_____
	(iii) Aggregate and selected individual participant data amounts used in the actuarial valuations.	_____	_____	_____
	(iv) 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 valuation.	_____	_____	_____
A B C F	e. For each cost-sharing multiple-employer defined benefit pension plan and defined contribution pension plan, determine by appropriate tests that:			
	(1) Annual pension expenditures/expenses equal contractually required contributions to the plan.	_____	_____	_____
	(2) Annual pension expenditures/expenses have been accounted for in the proper fund or account group.	_____	_____	_____
	(3) Amounts recognized as pension expenditures/expenses, liabilities, and assets are in conformity with generally accepted accounting principles.	_____	_____	_____
	(4) Disclosures in the notes to financial statements are in conformity with generally accepted accounting principles.	_____	_____	_____
F	f. Determine whether on-behalf payments made by other entities for fringe benefits for the entity's employees have been accounted for in accordance with GASB Statement No. 24.	_____	_____	_____
A B F	g. Schedule the expenditure/expense and liability accounts of other fringe benefits of material amount or unusual nature and perform audit procedures determined necessary.	_____	_____	_____
E	h. For fringe benefits charged to grant programs, determine whether the costs were allowable and otherwise complied with program requirements (such as that the amounts charged were based on amounts paid or amounts measured on a GAAP-basis, if applicable). <sup>8</sup>	_____	_____	_____
	<b>5. Postemployment Benefits Other Than Pension Benefits (OPEB)</b>			
A	a. If the entity provides OPEB, obtain a description of policies and a schedule of the costs for current year.	_____	_____	_____
A B C F	b. If the entity has opted to apply the provisions of GASB Statement No. 27 to postemployment healthcare benefits, determine whether the accounting and financial reporting conform to that Statement.	_____	_____	_____

<sup>8</sup> See footnote 2.



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
F	c. Review the entity's OPEB disclosures in the notes to financial statements for conformity with generally accepted accounting principles.	_____	_____	_____
	<b>6. Special Termination Benefits</b>			
A B F	a. If the entity has provided special termination benefits during the period, determine the authority for and propriety of such payments and whether the accounting and financial reporting for such payments and related liabilities is in accordance with generally accepted accounting principles.	_____	_____	_____
	<b>7. Municipal Solid Waste Landfill Closure and Postclosure Care Costs</b>			
[A] [B]	a. Review and document the entity's policies concerning estimating and accounting for municipal solid waste landfill closure and postclosure care costs.	_____	_____	_____
A B F	b. Obtain a copy of the entity's computation of costs for the current period and the liability as of year-end.	_____	_____	_____
	(1) 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.)	_____	_____	_____
	(2) Trace cumulative capacity used to supporting documentation. Compare to prior year's amount and current year's additions.	_____	_____	_____
	(3) Determine whether computations have been adjusted for inflation and current changes in federal, state, or local laws and regulations.	_____	_____	_____
	(4) Trace current period costs and total liability to financial statements and determine whether that accounting and reporting are proper for the applicable fund type.	_____	_____	_____
	c. Compare information obtained in preceding procedure with information disclosed in notes to financial statements and determine whether disclosures are in accordance with GASB Statement No. 18, <i>Accounting for Municipal Solid Waste Landfill Closure and Postclosure Care Costs</i> .	_____	_____	_____
	<b>8. Encumbrances and Other Commitments</b>			
D	a. Obtain a schedule of encumbrances outstanding at the end of the audit period.	_____	_____	_____
D	b. Reconcile the detail of encumbrances to general ledger amounts.	_____	_____	_____
D	c. Trace encumbrances (in excess of \$_____) to unfilled purchase orders.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
D	d. Inquire as to material unencumbered commitments, for example, to purchase or construct property and equipment or for year 2000 remediation.	_____	_____	_____
DF	e. Determine whether encumbrances and other significant commitments have been properly reported and disclosed in the financial statements.	_____	_____	_____
<b>9. Prepaid Items</b>				
[C]	a. Review the type and amount of prepaid items, such as:			
	(1) Unexpired insurance	_____	_____	_____
	(2) Prepaid rent	_____	_____	_____
	(3) Supplies inventories	_____	_____	_____
	(4) Advances	_____	_____	_____
	(5) Unamortized expenses	_____	_____	_____
	(6) Deposits	_____	_____	_____
	(7) Other (itemize):	_____	_____	_____
	_____	_____	_____	_____
CF	b. Review amounts for reasonableness by comparison with balances at the end of the preceding period, related expense accounts, and so forth.	_____	_____	_____
C	c. For material amounts, ascertain propriety of balances by review of calculations and supporting documents.	_____	_____	_____
C	d. Consider confirmation of balances.	_____	_____	_____
C	e. Trace selected amounts to disposition in subsequent period.	_____	_____	_____
F	f. Determine whether the accounting treatment, including the presentation of fund balance reserves, is in accordance with generally accepted accounting principles.	_____	_____	_____
<b>D. Overall Conclusions</b>				
1.	In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
a.	Expenditures/expenses reporting in the financial statements represent valid transactions and include all items that are applicable to the period.	_____	_____	_____
b.	Payable and accrued liabilities reported in the financial statements are properly authorized, represent the correct amounts of currently payable items, and reflect all outstanding obligations.	_____	_____	_____
c.	Prepaid items reported in the financial statements are valid, complete, and stated at the proper amount.	_____	_____	_____
d.	Encumbrances and other commitments are identified and recorded or disclosed.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
e. Expenditures/expenses are made in accordance with legal and contractual provisions.	_____	_____	_____
f. Financial statement presentation and disclosure of expenditures, expenses, payables, and prepaid items are in conformity with GAAP 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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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**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 used in the ordinary course of operations. (Assertions 3 and 5)
- C. Estimates of realizable value are carefully and consistently made. (Assertion 4)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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**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. \_\_\_\_\_

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>B. Analytical Procedures</b>				
	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.	_____	_____	_____
<b>C. Other Auditing Procedures</b>				
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 that could cause difficult or impossible count of items, and any other unusual conditions that need to be investigated.	_____	_____	_____
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
[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 used in the ordinary course of operations.
  - c. Cost of inventory items is measured in accordance with generally accepted accounting principles, consistently applied.
  - d. Estimates of realizable value are carefully and consistently made.

Except as follows:

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

Date

Done by \_\_\_\_\_

Reviewed by \_\_\_\_\_

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\_\_\_\_\_

The material included in this section relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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  
ByDateW/P  
Ref.

**VIII. Capital Expenditures and Related Fund and Account Group Activity**  
(for proprietary funds, use Audit Program in AAM section 5400.080)

**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 (GFAAG) 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 1 and 2)
- C. Capitalized costs and, if applicable, related depreciation associated with all fixed assets no longer owned or possessed have been removed from the GFAAG. (Assertions 1 and 3)
- 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. Depreciation, if recorded, is appropriately calculated. (Assertion 4)
- E. Leases are classified properly as capital or operating; fixed assets capitalized are classified properly by major classes of assets and related sources of funding; and related disclosures are adequate. (Assertions 4 and 5)
- F. Property transferred between the GFAAG and proprietary funds is appropriately reported. (Assertions 4 and 5)

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
G. The entity has complied with legal and contractual provisions relating to capital expenditures and capital assets. (Assertions 2 and 5)			
<p><b>Note:</b> 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, that is, [A], [B], and so forth, the audit procedures only secondarily accomplishes the objective.</p>			
<b>A. Evaluation of Internal Control</b>			
1. Review the understanding of internal control over capital expenditures and capital assets 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>B. Analytical Procedures</b>			
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.	_____	_____	_____
<b>C. Other Auditing Procedures—Capital Expenditures</b>			
A B G 1. Review minutes of governing authority for approval of purchase and construction contracts and for the fund to be charged.	_____	_____	_____
[A] [B] 2. Document the entity's capitalization policy.	_____	_____	_____
A B D G 3. Examine invoices or other documentation for capital expenditures during the period, considering matters such as:			
a. Whether the assets acquired conform to the terms of the purchase orders (or contracts and change orders for construction contracts).	_____	_____	_____
b. Whether amounts are paid are in accordance with the terms of the purchase orders or contracts/change orders.	_____	_____	_____



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
G	4. Where applicable, review bids for compliance with state or local bid laws and regulations.	_____	_____	_____
G	5. If the capital expenditures were charged to grant programs, determine whether the costs were allowable and otherwise complied with program requirements (such as equipment and real property management and the prevailing wage rate requirements of the Davis-Bacon Act). <sup>1</sup>	_____	_____	_____
B	6. Ascertain amounts of contracts payable, including retainage withheld, that are due but unpaid and trace to liability accounts in general ledger.	_____	_____	_____
[B]	7. 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	8. Trace selected capital expenditures into the GFAAG, noting agreement of description and amount, classification, related sources of funding, and compliance with capitalization policy.	_____	_____	_____
E	9. For construction projects completed during the year, ensure that capitalized amounts are transferred from construction in process to proper classification by major class of assets.	_____	_____	_____
<b>D. Other Auditing Procedures—Leases</b>				
[B]	1. Obtain copies of major leases for equipment and/or facilities.	_____	_____	_____
A B G	2. Review minutes of governing body for approval of lease agreement and the fund to be charged.	_____	_____	_____
[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 whether the transaction has been recorded in accordance with generally accepted accounting principles (GAAP) (as described in GASB Codification section L20).	_____	_____	_____
	b. Trace recording of cost of the asset to capital expenditure accounts.	_____	_____	_____
	c. Trace unpaid lease amounts to general long term debt account group (GLTDAG).	_____	_____	_____
B	5. Examine documentary support for lease payments.	_____	_____	_____

<sup>1</sup> This step is not necessary for federal grant expenditures if the auditor is conducting an audit in accordance with the provisions of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, concurrently with the financial statement audit and the scope of that A-133 audit is sufficient to provide reasonable assurance concerning the entity's compliance with grant requirements that have a direct and material effect on financial statement amounts.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
G	6. If lease expenditures were charged to grant programs, determine whether the costs were allowable and otherwise complied with program requirements. <sup>2</sup>	_____	_____	_____
E	7. Determine whether the disclosures about operating and capital leases in the notes to the financial statements are in conformity with GAAP.	_____	_____	_____
<b>E. Other Auditing Procedures—GFAAG</b>				
A	1. Obtain detailed listing of property records and reconcile with the appropriate control accounts in the general ledger.	_____	_____	_____
A	2. Physically inspect a sample of fixed assets and agree to the detailed property records.	_____	_____	_____
	3. Obtain a listing of fixed assets acquired during the year and vouch to documentation of the cost of the asset or the fair value at the date of donation.	_____	_____	_____
	4. Obtain a listing of fixed assets disposed of during the year:			
C G	a. Determine whether disposals were properly authorized (and, if applicable, properly advertised) and were removed from the detailed property records.	_____	_____	_____
	b. Trace proceeds into the record of cash receipts or receivables.	_____	_____	_____
G	c. Determine whether proceeds have been recorded in the proper fund in accordance with legal requirements.	_____	_____	_____
C	d. Determine whether fixed assets that have been sold, traded, demolished, or scrapped in conjunction with acquisitions during the period of new fixed assets have been appropriately reflected as disposals.	_____	_____	_____
G	e. If disposed assets were initially acquired with grant funds, determine whether the grantor's disposition requirements were followed. <sup>3</sup>	_____	_____	_____
C D	5. If the entity records an allowance for depreciation on general fixed assets, review the allowance for accuracy of additions and deletions during the year and reasonableness of ending balances.	_____	_____	_____
[A]	6. Document the entity's policy regarding insurance of general fixed assets:			
[A]	a. If applicable, inspect major insurance policies to determine coverage and compliance with entity's policy.	_____	_____	_____
F	7. Determine whether property transfers between the GFAAG and proprietary funds are appropriately reported.	_____	_____	_____

<sup>2</sup> See footnote 1.<sup>3</sup> See footnote 1.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>F. Overall Conclusions</b>			
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 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. 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. Depreciation, if recorded, if appropriately calculated.	_____	_____	_____
e. Leases are classified properly as capital or operating; fixed assets capitalized are classified properly by major classes of assets and related sources of funding; and related disclosures are adequate.	_____	_____	_____
f. Property transferred between the GFAAG and proprietary funds is appropriately reported.	_____	_____	_____
g. The entity has complied with legal and contractual provisions relating to capital expenditures and capital assets.	_____	_____	_____
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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and 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  
ByDateW/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 service expenditures reported in the financial statements represent valid transactions and include all items that are applicable to the period. (Assertions 1 and 2)
- B. Debt liabilities reported in the financial statements are properly authorized and reflect all outstanding obligations. (Assertions 1, 2, and 3)
- C. Debt transactions are made in accordance with legal and contractual provisions, including federal arbitrage restriction and rebate requirements. (Assertions 2 and 5)
- D. Financial statement presentation and disclosure of debt service transactions and balances (including restrictions, guarantees, commitments, conduit debt, and debt defeasances) are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 3, 4, and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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**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.

\_\_\_\_\_

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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>B. Analytical Procedures</b>				
	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.	_____	_____	_____
<b>C. Other Auditing Procedures—Short-term Obligations</b>				
B	1. Determine whether all bond, tax, and revenue anticipation notes and other short-term debt obligations have been properly authorized.	_____	_____	_____
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.	_____	_____	_____
C	4. Determine whether short-term obligations in excess of legal limitations have been issued.	_____	_____	_____
B	5. Examine supporting documents for debt service payments made during the period.	_____	_____	_____
A B	6. Review interest paid or accrued for reasonableness. Recompute on a test basis.	_____	_____	_____
C	7. Examine for compliance with legal and contractual provisions (for example, whether proceeds that were spent during the period were used for authorized purposes).	_____	_____	_____
D	8. Determine whether the entity's accounting, financial reporting, and disclosures for the notes are in conformity with GAAP.	_____	_____	_____
<b>D. Other Auditing Procedures—Bond and Interest Expenditures/Expenses</b>				
C	1. Examine provisions of bond ordinances and tax levies for retirement of bonds and interest and test compliance therewith, including:			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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 audit period to determine whether deposits/transfers are being made at intervals/dates required by the bond ordinance.	_____	_____	_____
A B	2.. Obtain the entity's maturity schedule for outstanding bonds:			
	a. Trace amounts maturing currently to expenditure/expense accounts for interest and principal.	_____	_____	_____
	b. Trace unmatured bond principal to general long term debt account group (GLTDAG) or the applicable proprietary fund(s).	_____	_____	_____
A B	3. Confirm directly with the paying agent the amounts transmitted to it during the year, the amount of bonds and interest retired during the year, and any year end balances (including canceled bonds and coupons).	_____	_____	_____
B	4. For bonds issued during the audit period:			
	a. Trace approval of issuance to minutes of governing body.	_____	_____	_____
	b. If applicable, review approval from third parties.	_____	_____	_____
C	5. Determine whether proceeds that were spent during the audit period were used for authorized purposes.	_____	_____	_____
D	6. Determine whether cash on hand with the paying agent is recorded as both an asset and a liability.	_____	_____	_____
C	7. Determine whether the total outstanding debt exceeds legal restrictions.	_____	_____	_____
D	8. Determine whether the entity's accounting, financial reporting, and disclosures for the bonds are in conformity with GAAP.	_____	_____	_____
	<b>E. Other Auditing Procedures—Long-term Obligations Other Than Bonds</b>			
B	1. Determine whether all obligations of this nature (such as loans and advances) have been properly authorized.	_____	_____	_____
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 the creditor.	_____	_____	_____
C	4. Determine whether proceeds that were spent during the audit period were used for authorized purposes.	_____	_____	_____
A B	5. Examine supporting documents for debt service payments made during the period.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B	6. Review interest paid or accrued for reasonableness. Recompute on a test basis.	_____	_____	_____
D	7. Determine whether the entity's accounting, financial reporting, and disclosures for the obligations are in conformity with GAAP.	_____	_____	_____
<b>F. Other Auditing Procedures—Federal Arbitrage Requirements and Arbitrage Refund Liabilities<sup>1</sup></b>				
C	1. Identify the specialist who will be involved in the examination of the entity's compliance with federal arbitrage restriction and rebate requirements and obtain information concerning the professional qualifications and reputation of the specialist, the nature of the work to be performed, and other information as required by SAS No. 73 [AU section 336].	_____	_____	_____
C	2. Review, as appropriate, the methods and assumptions used by the specialist in his or her evaluation of the entity's compliance with federal arbitrage restriction and rebate requirements.	_____	_____	_____
B C D	3. Obtain the entity's worksheets for computing its arbitrage liability.	_____	_____	_____
	a. Trace date and amount of deposits and disbursements to supporting accounting records.	_____	_____	_____
	b. Review the entity's computations for reasonableness.	_____	_____	_____
	c. Determine whether arbitrage liabilities have been recorded in the fund that will make the payment or the GLTDAG.	_____	_____	_____
D	4. Determine whether the entity has made appropriate disclosures if it has been advised of the possible loss of tax exempt status on bond issues for failure to comply with federal arbitrage restriction and rebate requirements.	_____	_____	_____
<b>G. Other Audit Procedures</b>				
D	1. Determine whether conduit debt obligations are in accordance with GASB Interpretation No. 2, <i>Disclosure of Conduit Debt Obligations</i> .	_____	_____	_____
D	2. Determine whether debt defeasances are in accordance with GASB Statement No. 7, <i>Advance Refundings Resulting in Defeasance of Debt</i> , and GASB Statement No. 23, <i>Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities</i> .	_____	_____	_____
<b>H. Overall Conclusions</b>				
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			

<sup>1</sup> The Government Finance Officers Association (GFOA) has three publications that discuss arbitrage requirements: *The GAAFR Review Practice Guide* (1997), *Guide to Arbitrage Requirements for Governmental Bond Issues* (1992) and *1994 Supplement to the Guide to Arbitrage Requirements for Governmental Bond Issues*.

Obj.

<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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- |   |       |       |       |
|---|-------|-------|-------|
| a. Debt service expenditures reported in the financial statements represent valid transactions and include all items that are applicable to the period.   | _____ | _____ | _____ |
| b. Debt liabilities reported in the financial statements are properly authorized and reflect all outstanding obligations.   | _____ | _____ | _____ |
| c. Debt transactions are made in accordance with legal and contractual provisions, including federal arbitrage restriction and rebate requirements.   | _____ | _____ | _____ |
| d. Financial statement presentation and disclosure of debt service transactions and balances (including restrictions, guarantees, commitments, conduit debt, and debt defeasances) are in conformity with generally accepted accounting principles (GAAP) 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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/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. Interfund transactions and changes in reserved, designated, and undesignated fund equity reported in the financial statements represent valid transactions and include all items that are applicable to the period. (Assertions 1 and 2)
- B. Interfund balances and fund equity reserves and designations are properly authorized and reflect all outstanding balances. (Assertions 1, 2, and 3)
- C. Interfund and fund equity transactions are made in accordance with legal and contractual provisions. (Assertions 2 and 5)
- D. Financial statement presentation and disclosure of interfund and fund equity transactions and balances are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 3, 4, and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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**A. Evaluation of Internal Control**

1. Review the understanding of internal control over interfund transactions and fund equity and the preliminary assessment of control risk.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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>B. Analytical Procedures</b>				
	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.	_____	_____	_____
<b>C. Other Auditing Procedures—Interfund Transactions</b>				
[A] [B] [D]	1. Determine the entity's policies for recognizing and classifying interfund transactions as quasi-external transactions, reimbursements, transfers, and loans.	_____	_____	_____
[A] [B]	2. Obtain or prepare a schedule of interfund transfers and loans and of all interfund account balances at year end.	_____	_____	_____
B D	3. Determine whether interfund receivables equal interfund payables.	_____	_____	_____
B C	4. Review minutes of the governing body, adopted budget, appropriate debt issuance documents, and other legal and contractual provisions for authorization of and any legal restrictions on interfund transactions.	_____	_____	_____
A B D	5. Determine whether interfund transactions are properly classified as quasi-external transactions, reimbursements, transfers (operating or residual equity) and loans and reported accordingly in the financial statements.	_____	_____	_____
A B D	6. Review ending balances of interfund accounts as to:			
	a. Aging of balances.	_____	_____	_____
	b. Reason for transactions.	_____	_____	_____
	c. Method of liquidation anticipated.	_____	_____	_____
	d. Proper reporting classification (for example, as "Due to/from" and "Advance to/from").	_____	_____	_____
	e. Collectibility.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>D. Other Auditing Procedures—Fund Equity</b>			
B 1. Review minutes of the governing body, charter, and debt issuance documents and other similar documents to identify the authorizations for fund equity reserves and designations.	_____	_____	_____
C D 2. Determine whether fund equity reserves and designations have been made in compliance with the applicable legal and contractual provisions and are properly disclosed in the financial statements, including disclosure of deficit fund balance or deficit retained earnings of individual funds.	_____	_____	_____
A B D 3. Analyze all transactions to fund balance and retained earnings accounts for the year to determine whether all such transactions are properly reported in the financial statements or notes.	_____	_____	_____
<b>E. Overall Conclusions</b>			
1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
a. Interfund transactions and changes in reserved, designated, and undesignated fund equity reported in the financial statements represent valid transactions and include all items that are applicable to the period.	_____	_____	_____
b. Interfund balances and fund equity reserves and designations are properly authorized and reflect all outstanding balances.	_____	_____	_____
c. Interfund and fund equity transactions are made in accordance with legal and contractual provisions.	_____	_____	_____
d. Financial statement presentation and disclosure of interfund and fund equity transactions and balances are in conformity with generally accepted accounting principles (GAAP) 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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/P  
Ref.**XI. Proprietary Funds—Special Topics**


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**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 found in proprietary funds have been separately addressed in this program.

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**Financial Statement Assertions**

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

**Audit Objectives**

- A. Proprietary fund revenue accounts include all transactions that relate to the period. (Assertions 1 and 2)
- B. Proprietary fund receivables are valid, complete, and stated at the net realizable amount. (Assertions 1, 2, 3, and 4)
- C. The costs associated with grant financed fixed assets are allowable and otherwise comply with program requirements. (Assertions 2 and 5)
- D. Contributed capital has been accounted for in accordance with generally accepted accounting principles (GAAP). (Assertions 4 and 5)
- E. Financial statement presentation and disclosure for proprietary funds are in conformity with GAAP consistently applied. (Assertions 4 and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

---

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>A. Evaluation of Internal Control</b>				
	1. Review the understanding of internal control over proprietary fund revenues, receivables, grant financed fixed assets, and contributed capital and deposits 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>B. Analytical Procedures</b>				
	1. Review the planning procedures applicable to analytical procedures performed on proprietary fund revenues, receivables, grant financed fixed assets, and contributed capital 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.	_____	_____	_____
<b>C. Other Auditing Procedures—Operating Revenues</b>				
[A]	1. Obtain rate schedules for services and determine whether rates have been properly authorized.	_____	_____	_____
A	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 revenues when compared to records showing the usage or consumption of goods or services.	_____	_____	_____
	(3) Compute average revenue per unit of usage or 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. Where charges are based on direct and allocated costs:			
	(1) Determine method used by the entity to accumulate direct costs and allocated costs to each customer.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(2) Trace direct costs into customers' ledger to determine whether costs have been properly accumulated.	_____	_____	_____
	(3) Recompute allocated costs to determine whether they have been properly assigned to individual customers.	_____	_____	_____
A	c. If cycle billing is used, obtain the entity's computation of unbilled service revenue and—			
	(1) Review for accuracy of computation.	_____	_____	_____
	(2) Trace billings to subsequent periods.	_____	_____	_____
	(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.	_____	_____	_____
<b>D. Other Auditing Procedures—Receivables</b>				
A B	1. Obtain aged listing of accounts receivable. Test accuracy of listing and reconcile the balance with the general ledger.	_____	_____	_____
B	2. Investigate individual accounts with large or unusual balances; trace to subsequent transactions.	_____	_____	_____
B	3. Consider confirming accounts receivable directly with customers. If receivables are not confirmed, however, the reason for nonconfirmation must be documented. Any 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.	_____	_____	_____
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 E	6. Review collectibility of accounts with responsible personnel and determine whether a proper allowance is established for uncollectible accounts.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>E. Other Auditing Procedures—Grant Financed Fixed Assets</b>				
C	1. If capital expenditures or capital use charges were charged to grant programs, determine whether the costs were allowable and otherwise complied with program requirements (such as equipment and real property management). <sup>1</sup>	_____	_____	_____
<b>F. Other Auditing Procedures—Contributed Capital</b>				
D	1. Analyze all changes in contributed capital during the period and determine whether those changes are in accordance with GAAP.	_____	_____	_____
D	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 reported as contributed capital.	_____	_____	_____
D	3. If depreciation on fixed assets financed by contributed capital is closed to contributed capital:			
	a. Determine whether the entity'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.	_____	_____	_____
D E	4. Determine whether the entity has properly disclosed changes in contributed capital in its financial statements.	_____	_____	_____
<b>G. Other Auditing Procedures—Reporting</b>				
E	1. If the entity's financial statements distinguish between operating and non-operating net income, review whether its classifications are proper and consistent with the prior-year's classifications.	_____	_____	_____
E	2. If the entity presents a classified balance sheet, review whether its classifications are in conformity with GAAP and consistent with the prior-year's classifications.	_____	_____	_____
E	3. Review whether the proprietary funds' cash flows statements are in conformity with GAAP and consistent with the prior-year's statements.	_____	_____	_____
E	4. Review whether the entity's use of Financial Accounting Standards Board pronouncements are in conformity with GAAP and consistent with the prior-year's use.	_____	_____	_____

<sup>1</sup> This step is not necessary for federal grant expenditures if the auditor is conducting an audit in accordance with the provisions of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, concurrently with the financial statement audit and the scope of that A-133 audit is sufficient to provide reasonable assurance concerning the entity's compliance with grant requirements that have a direct and material effect on financial statement amounts.

Obj.

Done  
By      Date      W/P  
                                 Ref.

H. Overall Conclusions

- 1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:
  - a. Proprietary fund revenue accounts include all transactions that relate to the period.
  - b. Proprietary fund receivables are valid, complete, and stated at the net realizable amount.
  - c. The costs associated with grant financed fixed assets are allowable and otherwise comply with program requirements.
  - d. Contributed capital has been accounted for in accordance with GAAP.
  - e. Financial statement presentation and disclosure for proprietary funds are in conformity with GAAP consistently applied.

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

Except as follows:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

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

\_\_\_\_\_  
Done by  
  
\_\_\_\_\_  
Reviewed by

\_\_\_\_\_  
Date  
  
\_\_\_\_\_



The material included in this section relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/P  
Ref.**XII. Risk Financing and Related Insurance 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 entity has adopted policies to provide reasonable coverage for risks of loss. (Assertion 3)
- B. The entity has complied with legal requirements relating to risk financing and related insurance activities. (Assertions 2 and 5)
- C. Expenditures/expenses reported in the financial statements for risk financing and related insurance activities represent valid transactions and include all items that are applicable to the period. (Assertions 1 and 2)
- D. Liabilities reported in the financial statements for risk financing and related insurance activities are properly authorized, represent the correct amounts of currently payable items, and reflect all outstanding obligations. (Assertions 1, 2, 3, and 4)
- E. Financial statement presentation and disclosure of risk financing and related insurance activity transactions and balances are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 3, 4, and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

---

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>A. Evaluation of Internal Control</b>				
	1. Review the understanding of internal control relative to risk financing and related insurance activities 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>B. Analytical Procedures</b>				
	1. Review the planning procedures applicable to analytical procedures performed on risk financing and related insurance activities 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.	_____	_____	_____
<b>C. Other Auditing Procedures—Risk Financing and Related Insurance Activities—General</b>				
A	1. Obtain a copy of the entity's policy relative to risk financing and related insurance activities.	_____	_____	_____
A B	2. Determine whether the policy has been considered and adopted by the governing body and is in accordance with legal and contractual provisions.	_____	_____	_____
A	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, public risk pool, and risk retention).	_____	_____	_____
A	a. Consider whether material risks of loss have not been addressed in the entity's policies.	_____	_____	_____
E	b. Review financial statements for adequacy of disclosure regarding entity's risk policies and, if applicable, any material uninsured risks.	_____	_____	_____
	4. If the entity purchases insurance coverage for identified risks—			
A	a. Determine compliance of purchased insurance with adopted policy.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C	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.	_____	_____	_____
E	c. From analysis of selected policies, determine whether there has been a transfer of risks. If not, determine whether premiums and claims have been properly recorded to reflect the continuing risks of refunds or assessments.	_____	_____	_____
E	d. If the entity pays insurance premiums in advance, determine whether prepaid insurance has been properly reported in the financial statements.	_____	_____	_____
	5. If the entity participates in a public entity risk pool(s)—			
A	a. Determine the type of public entity risk pool (that is, whether it involves a transfer or pooling of risk), the type of entity risk handled by each pool, and whether participation in the pool complies with adopted policy.	_____	_____	_____
C	b. Obtain a copy of the agreement with the 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.	_____	_____	_____
DE	c. Obtain a copy of the financial statements from the public entity risk pool and determine whether the audit entity has any continuing contingencies (asset or liability) relative thereto. If so, determine whether the entity has recorded that asset or liability.	_____	_____	_____
E	d. Determine whether capitalization contributions are appropriately reported and disclosed in accordance with GAAP.	_____	_____	_____
E	e. Review the notes to financial statements for adequacy of disclosures regarding risks being handled by public entity risk pool(s).	_____	_____	_____
B	6. Determine on a test basis whether, for risk financing and related insurance activity expenditures/expenses charged to grant programs (including those associated with risk retention programs), the costs were allowable and otherwise complied with grant program requirements (such as whether the charges were incurred during the grant period). <sup>1</sup>	_____	_____	_____
<b>D. Other Auditing Procedures—Risk Retention</b>				
A	1. Determine whether the entity's risk retention programs comply with its policies.	_____	_____	_____

<sup>1</sup> This step is not necessary for federal grant expenditures/expenses if the auditor is conducting an audit in accordance with the provisions of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, concurrently with the financial statement audit and the scope of that A-133 audit is sufficient to provide reasonable assurance concerning the entity's compliance with grant requirements that have a direct and material effect on financial statement amounts.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
D	2. For risks of loss retained by the entity, determine methods used to determine estimated losses from claims (including losses incurred but not reported).	_____	_____	_____
	a. If an actuarial report is used to record estimated losses, obtain a copy of the report and perform procedures relative thereto as required by SAS No. 73, <i>Using the Work of a Specialist</i> [AU section 336] including obtaining information concerning the professional qualifications and reputation of the actuarial firm, obtaining an understanding of the methods and assumptions used by the actuary, making appropriate tests of data provided to the actuary (taking into account the auditor's assessment of control risk), and evaluating whether the actuary's findings support the related assertions in the financial statements.	_____	_____	_____
	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.	_____	_____	_____
C D E	3. Determine whether claims and related expenditures/expenses have been recognized in accordance with GASB Codification section C50.	_____	_____	_____
C	4. Select a representative sample of claims paid and verify that the claimed losses were documented and that the payments made conform to program provisions.	_____	_____	_____
E	5. Determine whether annuity contracts purchased in a claimant's name have been properly accounted for and disclosed.	_____	_____	_____
	6. For risk retention programs accounted for within a general fund:			
D E	a. Determine whether 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.	_____	_____	_____
C E	b. Review the method of charging losses to other funds, and determine whether any amounts charged to other funds in excess of total expenditures and liabilities have been recorded as operating transfers.	_____	_____	_____
	7. For risk retention programs accounted for within an internal service fund:			
C D E	a. Determine whether premiums are:			
	(1) Recorded as charges for services in the internal service fund;	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(2) Recorded as expenditures/expenses of the insured funds; and,	_____	_____	_____
	(3) Based on the loss experience (or the loss experience plus a reasonable provision for future catastrophe losses) of the internal service fund and allocated to the insured funds on a reasonable basis.	_____	_____	_____
D E	b. Determine whether total claims payable are reported as internal service funds liabilities.	_____	_____	_____
E	c. Determine whether 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.	_____	_____	_____
	(2) Determine whether internal service fund deficits are properly disclosed in the notes to financial statements.	_____	_____	_____
D	8. Correspond directly with the entity's attorney handling claims under the risk retention program regarding large or unusual claims that have not been settled.	_____	_____	_____
D	9. Examine claims paid subsequent to the close of the fiscal year to determine the existence of unrecorded payables.	_____	_____	_____
E	10. Determine whether assets accumulated to pay claims are appropriately reported as reserved or designated.	_____	_____	_____
E	11. Determine the accuracy and completeness of related note disclosures, including disclosure of loss contingencies and retained earnings designated for future catastrophe losses.	_____	_____	_____
<b>E. Overall Conclusions</b>				
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. The entity has adopted policies to provide reasonable coverage for risks of loss.	_____	_____	_____
	b. The entity has complied with legal requirements relating to risk financing and related insurance activities.	_____	_____	_____
	c. Expenditures/expenses reported in the financial statements for risk financing and related insurance activities represent valid transactions and include all items that are applicable to the period.	_____	_____	_____
	d. Liabilities reported in the financial statements for risk financing and related insurance activities are properly authorized, represent the correct amounts of currently payable items, and reflect all outstanding obligations.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
e. Financial statement presentation and disclosure of risk financing and related insurance activity transactions and balances are in conformity with GAAP 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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/P  
Ref.**XIII. Fiduciary Funds (Other Than Pension and Investment Trust Funds)<sup>1</sup>****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 (GAAP). (Assertions 1, 2, 3, 4, and 5)
- B. Trust funds (other than pension and investment trust funds) are being maintained in compliance with the applicable legal or contractual provisions and are reported in accordance with GAAP. (Assertions 1, 2, 3, 4, and 5)
- C. Transactions of Internal Revenue Code Section 457 deferred compensation plans are properly accounted for and the plans are reported in accordance with GAAP. (Assertions 1, 2, 3, 4, and 5)

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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**A. Evaluation of Internal Control**

1. Review the understanding of internal control over fiduciary fund transactions and the preliminary assessment of control risk.

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<sup>1</sup> See AAM section 12,200.135 for pension trust funds. The Audit and Accounting Manual does not include an audit program for investment trust funds. The accounting and financial reporting requirements for those funds are in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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>B. Analytical Procedures</b>				
	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.	_____	_____	_____
<b>C. Other Auditing Procedures—Agency Funds</b>				
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 reports supporting payments to agency fund beneficiaries.	_____	_____	_____
A	5. Review presentation and note disclosure for conformity with GAAP.	_____	_____	_____
<b>D. Other Auditing Procedures—Trust Funds (Other Than Pension and Investment Trust Funds)</b>				
B	1. Obtain copies of documents establishing 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.	_____	_____	_____
B	5. Review presentation and note disclosure for conformity with GAAP.	_____	_____	_____



<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>E. Other Auditing Procedures—IRC Section 457 Deferred Compensation Plans</b>			
C 1. If the entity has a deferred compensation plan that meets the criteria for reporting in the financial statements: <sup>2</sup>			
C a. Confirm amounts on deposit in the plan directly with plan administrator and trace to the appropriate fund.	_____	_____	_____
C b. Test a sample of plan deposits reported by the administrator to the entity's records.	_____	_____	_____
C c. Confirm a sample of payments to plan participants.	_____	_____	_____
C d. Review presentation and note disclosure for conformity with GAAP.	_____	_____	_____
<b>F. Overall Conclusions</b>			
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 GAAP.	_____	_____	_____
b. Trust funds (other than pension and investment trust funds) are being maintained in compliance with the applicable legal or contractual provisions and are reported in accordance with GAAP.	_____	_____	_____
c. Transactions of Internal Revenue Code Section 457 deferred compensation plans are properly accounted for and the plans are reported in accordance with GAAP.	_____	_____	_____
Except as follows:			
_____			
_____			
_____			
This audit program has been completed in accordance with firm policy.			
		Date	
Done by _____		_____	
Reviewed by _____		_____	

<sup>2</sup> GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*, rescinds the provisions of GASB Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457*. That rescission is effective for financial statements for periods beginning after December 31, 1998, or when plan assets are held in trust under the requirements of IRC Section 457, subsection (g), if sooner.

The material included in this section relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/P  
Ref.**XIIIB. Pension Trust Funds<sup>1</sup>****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 authorized and properly represent investments owned by the pension trust fund and held either on hand or in custody and safekeeping by others on behalf of the pension trust fund. (Assertions 1, 2, and 3)
- B. Contributions amounts received by and due to the plan have been determined in accordance with plan provisions and are valid, complete, and stated at the net realizable amount. (Assertions 1, 2, 3, and 4)
- C. Benefit payment amounts and related liabilities conform to plan provisions, represent the correct amounts of currently payable items, and reflect all outstanding obligations. (Assertions 1, 2, 3, and 4)
- D. Financial statement representations and disclosures are consistent with actuarial findings. (Assertions 4 and 5)
- E. Financial statement presentation and disclosure of the pension trust fund and its transactions and balances are in conformity with generally accepted accounting principles (GAAP) consistently applied. (Assertions 3, 4, and 5)
- F. Required supplementary information and the related note disclosures are presented in accordance with GAAP consistently applied. (Assertions 3, 4, and 5)

<sup>1</sup> This audit program is based on the accounting and financial reporting requirements of GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. If the defined benefit pension plan administers one or more postemployment healthcare plans, see also the provisions of GASB Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<p><b>Note:</b> 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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.</p>			
<b>A. Evaluation of Internal Control</b>			
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>B. Analytical Procedures</b>			
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.	_____	_____	_____
<b>C. Other Auditing Procedures—General</b>			
[A] [B] [C] 1. Obtain copies of the following documents, if applicable:			
[D] [E] [F]			
a. Pension plan instruments, including amendments.	_____	_____	_____
b. State and local laws and regulations authorizing the pension plan.	_____	_____	_____
c. Minutes of meetings of the plan's 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 plan.	_____	_____	_____
g. Current actuary's report on the pension plan.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>D. Other Auditing Procedures—Investments and Net Investment Income</b>				
A E	1. Obtain a schedule of investments and determine that the investments made are in accordance with the provisions of plan instruments and laws and regulations governing the plan.	_____	_____	_____
	<i>a.</i> Trace selected investment transactions to approval in minutes of governing board or other documentation of authorization.	_____	_____	_____
	<i>b.</i> Reconcile balances to financial statements.	_____	_____	_____
A	2. Obtain evidence (by confirmation or physical count) concerning the existence and ownership of and custodial arrangements for the investments.	_____	_____	_____
A	3. Obtain information concerning any liens, pledges, or other security interests relating to the plan's investments by reviewing minutes, agreements, and confirmations.	_____	_____	_____
A E	4. Perform such procedures as necessary to satisfy the audit objectives concerning plan investments administered by trustees or other parties and reconcile the confirmed balances and transactions with amounts recorded and reported by the entity.	_____	_____	_____
D E	5. Determine that interest, dividend, and other income and investment expenses have been properly recorded and displayed in the financial statements.	_____	_____	_____
D E	6. Determine that investments are recorded at fair value and that all changes in fair value are recorded in the financial statements. [Note that unallocated insurance contracts may be reported at contract value, nonparticipating interest-earning investment contracts should be reported using cost-based measures, and allocated insurance contracts should be excluded from plan assets.]	_____	_____	_____
E	7. Review note disclosures for pension plan investments and investment income for conformity with GAAP.	_____	_____	_____
<b>E. Other Auditing Procedures—Contributions and Related Receivables</b>				
B	1. Obtain lists of participating employers (for multi-employer plans), plan members (for single-employer plans), and contribution sources other than participating employers and plan members.	_____	_____	_____
B	2. Obtain schedules showing, by contribution source, contributions received or receivable and compare to the lists of participating employers, plan members, and other contributors.	_____	_____	_____
B	3. Test contribution reports for arithmetical accuracy, use of proper contribution rates or amounts, and use of proper payroll or salary base amount.	_____	_____	_____
B	4. Test a sample of items from the contribution reports to participant records and from participant records to contribution reports.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
B	5. Reconcile contributions received to the plan's receipt records or trustee records.	_____	_____	_____
B	6. Confirm amounts contributed and receivable directly with selected contributors.	_____	_____	_____
E	7. Review the presentation of contributions in the statement of plan net assets for conformance with GAAP.	_____	_____	_____
B E	8. Review accruals of contribution receivables for conformance with GAAP and determine the reasonableness of allowances for doubtful accounts.	_____	_____	_____
E	9. Review note disclosures relative to pension plan contributions and related receivables.	_____	_____	_____
<b>F. Other Auditing Procedures—Benefit Payments and Payables</b>				
C	1. Obtain schedule of pension payments made during the year (including any lump sum refunds, if applicable, to members withdrawing from the plan and certain payments to and by insurance companies for and from annuities) and reconcile to general ledger accounts.	_____	_____	_____
	a. Refer to plan provisions and recompute monthly benefits to selected members (or to their beneficiaries) for members who began to draw benefits during the period under audit.	_____	_____	_____
	b. For selected members withdrawing from the system during the year, trace refunds to supporting documentation.	_____	_____	_____
	c. Test payments made during the year to selected members who retired in prior years (or to their beneficiaries) to determine that benefits are in accordance with plan provisions.	_____	_____	_____
B	2. Evaluate the continued eligibility of plan members or beneficiaries to whom payments have been made over an unusually long period of time.	_____	_____	_____
B	3. Investigate benefit payment checks that have been outstanding for a long period of time.	_____	_____	_____
B E	4. Evaluate benefit payment accruals for conformance with GAAP.	_____	_____	_____
<b>G. Other Auditing Procedures—Other Financial Statement Elements and Disclosures</b>				
E	1. Test the records of plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, and leasehold improvements) to ensure that additions, deletions, and depreciation or amortization of those assets is properly recorded.	_____	_____	_____
E	2. Determine how the administrative expenses of the plan are paid and whether there is appropriate disclosure of that financing source.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
E	3. Determine whether the plan's legally required reserves have been calculated in accordance with plan instruments and laws and regulations and whether those amounts are properly disclosed.	_____	_____	_____
E	4. Determine that the pension plan is properly described in the notes to the financial statements and that a summary of significant accounting policies is included.	_____	_____	_____
<b>H. Other Auditing Procedures—Participants' Data and Actuarial Valuations</b>				
B C D	1. By reviewing pertinent sections of the plan instruments, laws and regulations, and policies, identify participant data that should be tested because of its use in determining vesting, eligibility, or benefit amounts (for example, demographic data, payroll data, benefit levels and options, and so forth).	_____	_____	_____
B C 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, and so forth).			
	a. For selected employees, recompute vesting and compare to the entity's records.	_____	_____	_____
B C D	3. For selected employees, trace payroll data to participant file data.	_____	_____	_____
B C D	4. Test whether new employees during the period were properly enrolled as plan members as provided in the plan instruments.	_____	_____	_____
D	5. 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 <sup>2</sup>			
	(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 that 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.	_____	_____	_____

<sup>2</sup> See the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix N, "Illustrative Request to Actuary for Confirmation of GASB Pension Information."

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	d. Verify the accuracy and completeness of the participant data used in the actuarial valuations.	_____	_____	_____
	<b>I. Review Procedures—Required Supplementary Information</b>			
F	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 GASB standards.	_____	_____	_____
	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.	_____	_____	_____
E F	2. Compare the historical trend 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 standards.	_____	_____	_____
F	3. Consider whether representations on required supplementary information should be included in the request for the management representation letter.	_____	_____	_____
	<b>J. Overall Conclusions</b>			
	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 authorized and properly represent investments owned by the pension trust fund and held either on hand or in custody and safekeeping by others on behalf of the pension trust fund.	_____	_____	_____
	b. Contributions amounts received by and due to the plan have been determined in accordance with plan provisions and are valid, complete, and stated at the net realizable amount.	_____	_____	_____
	c. Benefit payment amounts and related liabilities conform to plan provisions, represent the correct amounts of currently payable items, and reflect all outstanding obligations.	_____	_____	_____
	d. Financial statement representations and disclosures are consistent with actuarial findings.	_____	_____	_____
	e. Financial statement presentation and disclosure of the pension trust fund and its transactions and balances are in conformity with GAAP consistently applied.	_____	_____	_____

Obj.Done  
ByDateW/P  
Ref.

- f. Required supplementary information and the related note disclosures are presented in accordance with GAAP 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 relates only to the general purpose financial statements of state and local governments (that is, not to the additional requirements of comprehensive annual financial reports) and is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.

<u>Done</u>	<u>Date</u>	<u>W/P</u>
<u>By</u>		<u>Ref.</u>

**XIV. Financial Reporting (See also the engagement administration and supervision program at AAM section 12,200.010)**

**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 (GAAP) consistently applied (or in accordance with another comprehensive basis of accounting), including all required disclosures. (Assertions 1, 2, 3, 4, and 5)
- B. The financial statements include appropriate recognition or disclosure of events or transactions occurring after the balance-sheet date but before the date of our report (subsequent events). (Assertions 1, 2, 3, 4, and 5)
- C. Our report on the examination is appropriately worded, and in conformity with generally accepted auditing standards.

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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**A. Other Auditing Procedures**

- A 1. Post all adjusting and reclassification journal entries that have properly been approved by firm and entity personnel to the working papers, and give a copy of appropriate entries to the entity to post to the accounting records.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A	2. Prepare a summary of passed adjustments that reflects the net effect of such adjustments on individual fund/fund type, account group, and discretely presented component unit column assets, liabilities, equity, revenue, and expenditures.	_____	_____	_____
	a. Determine if the overall effect on each fund type, account group, and discretely presented component unit column 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.	_____	_____	_____
A	4. Obtain a signed management representation letter from responsible entity officials. In addition to representations normally obtained in a GAAS audit (see SAS No. 85, <i>Management Representations</i> [AU section 333]), consider obtaining additional representations regarding:			
	a. Management's acknowledgment of its responsibility for compliance with laws, regulations, and provisions of contracts and grant agreements applicable to the entity (including budget laws and ordinances).	_____	_____	_____
	b. Management's acknowledgment of its responsibility for establishing and maintaining internal control over financial reporting.	_____	_____	_____
	c. Management's acknowledgment that it has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.	_____	_____	_____
	d. Management's acknowledgment that it has identified and disclosed to the auditor violations (or possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.	_____	_____	_____
	e. The financial reporting entity's financial statements to be audited.	_____	_____	_____
	f. The inclusion of all component units and the disclosure of all joint ventures and other related organizations.	_____	_____	_____
	g. The proper classification of funds and account groups.	_____	_____	_____
	h. The proper approval of reserves and designations of fund equities.	_____	_____	_____
	i. Compliance with any tax or debt limits and debt covenants.	_____	_____	_____
	j. Status of environmental related matters, including identification of any known or potential contamination requiring remediation.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	k. Representations relative to FASB- and GASB-required supplementary information.	_____	_____	_____
A	5. Inquire of management as to the existence, amount, and reporting of contingencies and commitments with respect to such matters as:			
	a. Sales of assets and agreements to repurchase assets previously sold.	_____	_____	_____
	b. Guarantees or endorsements.	_____	_____	_____
	c. Long-term leases.	_____	_____	_____
	d. Projects with other governmental entities that require annual payments.	_____	_____	_____
	e. Commitments to purchase large quantities of materials or services, including services for the year 2000 remediation of systems and equipment.	_____	_____	_____
	f. Commitments related to the construction, expansion, or rehabilitation of facilities.	_____	_____	_____
	g. Tax refund claims.	_____	_____	_____
	h. Possible claims for disallowed costs or expenditures incurred under a federal financial assistance program.	_____	_____	_____
	i. Contingencies related to risk financing and related insurance activities.	_____	_____	_____
A	6. Review legal fees for the period for indication of possible contingent liabilities.	_____	_____	_____
A B	7. 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.	_____	_____	_____
A B	8. Mail a letter of audit inquiry to the entity's attorney(s) to obtain corroboration of the information furnished by management concerning litigation, claims, and assessments.	_____	_____	_____
A B	9. Determine whether replies received from attorneys are complete, dated no more than two weeks before the date of the auditor's report (if not, obtain an oral or written update), and that all matters discussed therein have been considered for possible disclosure in the financial statements.	_____	_____	_____
A	10. Perform analytical procedures for overall review purposes.	_____	_____	_____
<b>B. Other Auditing Procedures—Review of Subsequent Events</b>				
<b>Scope of Review</b>				
From: _____ (Audit date)				
To: _____ (Report date—last date of significant field work)				

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
B	1. Review interim financial statements for periods subsequent to the balance-sheet date and compare them to the statements being reported on as well as to statements for comparable prior periods. Investigate any significant differences, results, events, or changes in accounting methods.	_____	_____	_____
B	2. Scan general ledger for subsequent period for any unusual entries or transactions and obtain explanation of entries noted.	_____	_____	_____
B	3. Review minutes of governing body and important committee meetings from audit date through _____ and consider whether any matters included in those minutes require further investigation to determine whether the financial statements should be adjusted or disclosure regarding subsequent events should be made in the notes to financial statements.	_____	_____	_____
B	4. Review the subsequent year's budget(s) for items that may indicate subsequent events that may require recognition or disclosure.	_____	_____	_____
B	5. 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, and so forth.	_____	_____	_____
	b. New debt issuances 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. Year 2000 remediation plans.	_____	_____	_____
	e. Others (list as applicable):	_____	_____	_____
	_____	_____	_____	_____
	_____	_____	_____	_____
	<b>C. Other Auditing Procedures—Report<sup>1</sup></b>			
C	1. Determine whether all required disclosures are included in the financial statements or notes. See AICPA <i>Checklists and Illustrative Financial Statements for State and Local Governmental Units</i> and any disclosure standards issued since the checklists were issued (for example, GASB Technical Bulletin 98-1, <i>Disclosures about Year 2000 Issues</i> ).	_____	_____	_____

<sup>1</sup> This program only addresses the financial statements and the auditor's report on them. For other reporting requirements of generally accepted auditing standards, see AAM section 12,200.010. For reporting requirements of *Government Auditing Standards* and OMB Circular A-133, see AAM section 12,200.150.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C      2. Determine whether the independent auditors' report is appropriately worded. (See the illustrative reports at AAM section 12,400.)	_____	_____	_____
C      3. Have the entity review and approve the final draft of the financial statements.	_____	_____	_____
<b>D. Overall Conclusions</b>			
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 GAAP consistently applied (or in accordance with an other comprehensive basis of accounting), including all required disclosures.	_____	_____	_____
b. The financial statements include appropriate recognition or disclosure of events or transactions occurring after the balance-sheet date but before the date of our report (subsequent events).	_____	_____	_____
c. Our report on the examination is appropriately worded, and in conformity with generally accepted auditing standards.	_____	_____	_____
Except as follows:			
_____			
_____			
_____			
This audit program has been completed in accordance with firm policy.			
		Date	
Done by _____		_____	
Reviewed by _____		_____	

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done  
ByDateW/P  
Ref.

## XV. Federal Financial Assistance (OMB Circular A-133 Single Audits)<sup>1</sup>

### Audit Objectives

- A. All federal awards received and expended and the federal programs under which they were received are identified in the entity's accounts.
- B. The entity's internal control over federal programs provides reasonable assurance that it is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its major federal programs.
- C. The entity has complied with laws, regulations, and the provisions of contracts or grant agreements related to each of its major federal programs.
- D. The entity has prepared appropriate financial statements, including the schedule of expenditures of federal awards, and completed its sections of the data collection form.
- E. The single audit has been properly performed and submitted when due.
- F. The entity has followed up on and taken corrective action on audit findings, including preparing a summary schedule of prior audit findings and a corrective action plan.

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**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, that is, [A], [B], and so forth, the audit procedure only secondarily accomplishes the objective.

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<sup>1</sup> This audit program does not address program-specific audits in accordance with OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. A checklist for an A-133 program-specific audit is in the AICPA's Practice Aid Series, *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations* (Single Audit Practice Aid). This audit program also does not address compliance audits of state, local, or nongovernmental grants, which are not covered by OMB Circular A-133. See the AICPA's Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, paragraphs 3.47 through 3.49 for a brief discussion of some the considerations in auditing such grants.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>A. Audit Planning</b>				
E	1. Determine whether we have communicated with the entity's management (for example, through the engagement letter or audit contract) that we will be performing a single audit of the entity's federal awards.	_____	_____	_____
E	2. Determine whether the amount of the entity's expenditures of federal awards makes it subject to a single audit.	_____	_____	_____
E	3. Determine whether we are restricted from conducting the single audit because we prepared the indirect cost rate proposal or the cost allocation plan.	_____	_____	_____
[E]	4. Determine whether the timing of the audit is appropriate to enable the entity to comply with the OMB Circular A-133 report submission deadline.	_____	_____	_____
E	5. Review applicable laws, regulations, and other material governing the performance of the single audit of federal financial assistance. (See the listing of reference materials at AAM section 12,210.)	_____	_____	_____
E F	6. Obtain and review a copy of the entity's prior-year single audit reporting package, determine whether it was submitted to all appropriate parties when due, and evaluate the status of corrective action on the reported findings.	_____	_____	_____
A B C	7. Review and discuss with responsible officials the policies and procedures used to account for and administer federal programs as well as the administration of federal programs during the audit period. Cover issues such as correspondence from and monitoring visits by federal agencies or pass-through entities, new or newly-administered federal programs, changes in program laws, regulations, and compliance requirements, subrecipient monitoring, the use of computer processing, and changes in entity personnel responsible for federal programs.	_____	_____	_____
D F	8. Determine whether the entity understands and is prepared to meet its reporting responsibilities under OMB Circular A-133. Discuss with the entity the format desired for the single audit reports (such as whether they are to be included in the comprehensive annual financial report or issued separately.)	_____	_____	_____
D	9. Determine whether the entity has prepared financial statements that reflect its financial position, results of operations, and, where appropriate, cash flows.	_____	_____	_____
A D E	10. Obtain the current-year schedule of expenditures of federal awards (which may only be available in draft), reconcile the schedule to the general accounting records, and:			
	a. Determine whether the period covered by the schedule is the same as that covered by the financial statements.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	b. Determine whether the schedule:			
	(1) Includes all types of federal financial assistance as defined by OMB Circular A-133, paragraph .105.	_____	_____	_____
	(2) Includes the minimum data elements required by OMB Circular A-133, paragraph .310(b), including notes that describe the significant accounting policies used. <sup>2</sup>	_____	_____	_____
	(3) Reports "awards expended" based on the definitions in OMB Circular A-133, paragraph .205.	_____	_____	_____
	(4) Uses measurements or presentations that differ from those used in the prior period. (If yes, how and why?)	_____	_____	_____
	(5) Has any significant assumptions or interpretations underlying the measurements or presentation.	_____	_____	_____
	(6) Can be reconciled to the amounts presented in the financial statements.	_____	_____	_____
A D E	11. Determine the "entity" for single audit purposes (that is, whether the single audit will be an organization-wide audit or a series of audits of individual departments, agencies, and other organizational units) and whether the financial statements and the schedule of expenditures of federal awards are for the same organizational unit.	_____	_____	_____
E	12. Where appropriate, contact the cognizant agency and receive input on important areas.	_____	_____	_____
E	13. Consider any issues relating to joint audits or reliance on other auditors.	_____	_____	_____
E	14. Consider the effect of using the work of the entity's internal auditors.	_____	_____	_____
E	15. Evaluate whether the entity qualifies as a low-risk auditee.	_____	_____	_____
E	16. Consider an approach to auditing indirect costs.	_____	_____	_____
E	17. Identify those federal programs administered by the entity that constitute clusters of programs.	_____	_____	_____
[C] E	18. Risk assess federal programs as needed and determine the major federal programs, making sure that the percentage-of-coverage requirement is met and that the risk analysis process used in determining major programs is documented. <sup>3</sup>	_____	_____	_____
E	19. Compute planning materiality for each major program.	_____	_____	_____

<sup>2</sup> A checklist of requirements for the schedule of expenditures of federal awards is in the AICPA's Single Audit Practice Aid. The schedule's requirements are also discussed in Chapter 5 of SOP 98-3 (AICPA, *Technical Practice Aids*, AUD section 11,320.05).

<sup>3</sup> A checklist for assessing federal program risk and a worksheet for determining major programs for single audits is in the AICPA's Single Audit Practice Aid.



<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
[C] E	20. Obtain from management the requirements of the laws, regulations, and provisions of contracts or grant agreements applicable to major programs.	_____	_____	_____
[C] E	21. Review any correspondence between the entity and the federal grantor and pass-through agencies applicable to major programs.	_____	_____	_____
[C] E	22. Consider the effect that multiple service locations will have on the compliance audit of major programs.	_____	_____	_____
[C] E	23. Identify the compliance requirements that could have a direct and material effect on each major program.	_____	_____	_____
E	24. Determine whether the audit of the financial statements has been or will be performed in accordance with Government Auditing Standards (GAS). If not, perform the following:			
	a. Determine whether we have communicated (for example, in the engagement letter) to the entity's audit committee or to the individuals with whom we have contracted for the audit:			
	(1) Our responsibilities in a financial statement audit, including our responsibility for testing and reporting on internal controls and compliance with laws and regulations.	_____	_____	_____
	(2) The nature of any additional testing of internal controls and compliance required by laws and regulations.	_____	_____	_____
	(3) The difference between items (1) and (2) and other financial related audits of internal control and compliance.	_____	_____	_____
	(4) If this communication was made orally, determine whether the communication is documented in the working papers.	_____	_____	_____
	b. Determine whether firm personnel assigned to the engagement have met the continuing education and training requirements and qualification standards of GAS.	_____	_____	_____
	c. Determine whether the firm has an appropriate internal quality control system and a current external quality control review.	_____	_____	_____
	d. Determine whether other firms, if any, that participate in the audit have met the GAS requirements for continuing education and training, an appropriate internal quality control system, and a current external quality control review.	_____	_____	_____
	e. Follow-up on known material findings and recommendations from previous audits that could affect the financial statement audit and determine whether the entity has taken timely and appropriate corrective action.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	f. Plan the audit to provide reasonable assurance of detecting misstatements resulting from noncompliance with provisions of contracts and grant agreements (in addition to laws and regulations) that have a direct and material effect on the determination of financial statement amounts. <sup>4</sup>	_____	_____	_____
	<b>B. Internal Control Over Compliance<sup>5</sup></b>			
B	1. For each compliance requirement that could have a direct and material effect on each major program as identified above:			
	a. Associate each compliance requirement to one of the fourteen types of compliance requirements listed in the OMB <i>Compliance Supplement</i> .	_____	_____	_____
	b. Identify specific internal control policies and procedures relevant to each compliance requirement that are likely to prevent or detect material noncompliance and perform a preliminary assessment of control risk. (If a low assessed level of control risk for a compliance requirement cannot be planned, go to step e.)	_____	_____	_____
	c. Perform tests of controls to evaluate the effectiveness of the design and operation of the controls (for example, through inquiry of appropriate personnel, inspection of documents and reports, observation of the application of specific controls, and reperformance of the application of controls), and assess control risk.	_____	_____	_____
	d. Document in the working papers the internal control tests performed, the results of those tests, and the basis for conclusions concerning the level of control risk.	_____	_____	_____
	e. For those compliance requirements for which a low assessed level of control risk could not be achieved, document that conclusion in the working papers and, if appropriate, draft a reportable condition or material weakness audit finding. <sup>6</sup>	_____	_____	_____
B E	2. Evaluate the effect that the audit findings relating to internal control over compliance have on our report on internal control over compliance with OMB Circular A-133.	_____	_____	_____
	<b>C. Compliance</b>			
C	1. For each type of compliance requirement applicable to each major program:			

<sup>4</sup> SAS No. 54, *Illegal Acts by Clients* (AU section 317), requires the auditor to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. *Government Auditing Standards*, paragraph 4.13, extends this requirement to the provisions of contracts and grant agreements.

<sup>5</sup> See the internal control objectives and characteristics of internal control over compliance with federal awards in AAM section 12,040.

<sup>6</sup> For purposes of reporting internal control audit findings in accordance with OMB Circular A-133, reportable conditions and material weaknesses are evaluated in relation to a type of compliance requirement for a major program or an audit objective identified in the OMB *Compliance Supplement*. Also, reportable conditions may individually or cumulatively be material weaknesses.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	a. Consider the understanding of internal control, the assessed level of control risk (together with an assessment of inherent risk), the acceptable level of detection risk, and other appropriate factors to determine the nature, timing, and extent of substantive compliance tests.	_____	_____	_____
	b. Identify audit objectives and audit procedures using the OMB <i>Compliance Supplement</i> . (See the audit program for tests of compliance requirements at AAM section 12,200.160.)	_____	_____	_____
	c. Determine the numbers and types of transactions to test.	_____	_____	_____
	d. Perform compliance tests, expanding or adjusting those tests as needed for identified noncompliance.	_____	_____	_____
	e. Document in the working papers the compliance tests performed and the results of those tests.	_____	_____	_____
	f. As appropriate, draft audit findings for identified noncompliance required to be reported.	_____	_____	_____
C E	2. Evaluate the effect that the audit findings relating to compliance with major programs have on our opinion on compliance with requirements applicable to each major program.	_____	_____	_____
E	3. If the audit of the financial statements has not been performed in accordance with GAS:			
	a. Perform tests to determine whether there are misstatements resulting from noncompliance with provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.	_____	_____	_____
	b. If specific information comes to our attention that provides evidence of the existence of possible illegal acts related to the provisions of contracts and grant agreements that could have a material indirect effect on the financial statements, apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.	_____	_____	_____
	c. As appropriate, draft audit findings related to identified noncompliance and illegal acts.	_____	_____	_____
	d. Evaluate the effect that the audit findings relating to compliance over financial reporting—including those identified during our audit of the financial statements in accordance with generally accepted auditing standards—have on our report on compliance based on an audit of financial statements performed in accordance with GAS.	_____	_____	_____
C E	4. Evaluate the effect that the audit findings relating to compliance with major programs and over financial reporting have on our opinion on the financial statements.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<b>D. Other Procedures</b>				
B C	1. Determine whether indirect or allocated costs have been appropriately audited through the testing of major programs. If not, perform appropriate procedures to evaluate internal control and to determine whether the costs charged to cost pools that were used to calculate the indirect cost rate or that were allocated through the cost allocation plan or indirect cost rate agreement were proper.	_____	_____	_____
A D	2. Consider whether the information in the schedule of expenditures of federal awards is consistent with the audited financial statements and other knowledge obtained during the audit of the financial statements.	_____	_____	_____
F	3. Follow-up on prior audit findings and perform procedures to assess the reasonableness of the entity's summary schedule of prior audit findings. Draft current-year audit findings if the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding.	_____	_____	_____
D	4. Perform procedures to determine whether subsequent events relating to federal programs are appropriately reported and disclosed in the financial statements and schedule of expenditures of federal awards.	_____	_____	_____
E	5. Determine whether working papers for the financial statement and single audits contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditors' significant conclusions and judgments, including the following:	_____	_____	_____
	a. The objectives, scope, and methodology, including any sampling criteria used.	_____	_____	_____
	b. Documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records.	_____	_____	_____
	c. Evidence of supervisory reviews of the work performed.	_____	_____	_____
E	6. Determine that the firm has established policies or procedures for complying with the single audit 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 or oversight agency for audit (or its designee), federal agencies providing direct or indirect funding, or the GAO at the completion of the audit.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B C D E F	7. Obtain a signed management representation letter from responsible entity officials that covers representations relating to the single audit, dated no earlier than the date of the auditor's report. <sup>7</sup>	_____	_____	_____
	8. Consider holding a closing or exit conference with senior officials of the entity upon the completion of fieldwork. Document the names of the attendees, comments made by the entity representatives, and other details.	_____	_____	_____
<b>E. Reporting<sup>8</sup></b>				
E	1. If the audit identified fraud or illegal acts, determine whether we have complied with the direct reporting requirements of GAS, paragraphs 5.21 through 5.25, even if we resigned or were dismissed from the audit.	_____	_____	_____
E	2. Prepare the independent auditor's report on the financial statements, if not previously prepared. Determine whether it states that the audit was conducted in accordance with GAS. (See the illustrative reports at AAM section 12,400.01 through 12,400.17.)	_____	_____	_____
A D E	3. Obtain a final copy of the schedule of expenditures of federal awards and compare it to information in the working papers.	_____	_____	_____
E	4. Prepare the auditor's report on the schedule of expenditures of federal awards, either as part of the report on the financial statements or as part of the report on compliance with requirements applicable to each major program and on internal control over compliance with OMB Circular A-133. (See the illustrative reports at AAM sections 12,400.17 and .20 through .23.)	_____	_____	_____
E	5. If not previously done, prepare the auditor's report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with GAS. (See the illustrative reports at AAM section 12,400.18 and .19.)	_____	_____	_____
E	6. Prepare the auditor's report on compliance with requirements applicable to each major program and on internal control over compliance with OMB Circular A-133. (See the illustrative reports at AAM section 12,400.20 through .23.)	_____	_____	_____
E	7. Prepare a schedule of findings and questioned costs that includes a summary of auditor's results, findings related to the financial statements that are required to be reported in accordance with GAS, and findings and questioned costs for federal awards. (See the illustrative schedule at AAM section 12,400.26.)	_____	_____	_____
E	8. Review all audit findings to determine whether they include all appropriate details.	_____	_____	_____

<sup>7</sup> A checklist of management representations relative to single audits and an illustrative management representation letter for single audit representations is in the AICPA's Single Audit Practice Aid.

<sup>8</sup> Audit reporting checklists for single audits are in the AICPA's Single Audit Practice Aid and the AICPA's *Checklists and Illustrative Financial Statements for State and Local Governmental Units* (September 1998).

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
E	9. Determine whether the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit are reported either in the schedule of findings and questioned costs or the entity's summary schedule of prior audit findings.	_____	_____	_____
E	10. Communicate to the entity all deficiencies in internal control that are not reportable conditions, preferably in writing as a management letter to top management. Document any such oral communication in the working papers. If a management letter is issued, determine whether the auditor's report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with GAS refers to it.	_____	_____	_____
DE	11. Complete the appropriate sections of the data collection form and review the sections of the form prepared by the entity.	_____	_____	_____
E	12. Determine whether all reports and the auditor's signature in the data collection form are appropriately dated.	_____	_____	_____
	13. Review the report drafts with appropriate entity officials.	_____	_____	_____
F	14. Determine whether the entity has prepared a corrective action plan that addresses each audit finding included in the current year report.	_____	_____	_____
DEF	15. Determine whether the single audit reporting package includes all required reports and schedules.	_____	_____	_____
E	16. In accordance with paragraph 5.32 of GAS, determine whether the audit reports are distributed to the appropriate entity officials, appropriate officials of the organization requiring or arranging for the audit (unless legal restrictions prevent it), other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations, and to others authorized to receive such reports.	_____	_____	_____
E	17. Provide the entity with a sufficient number of copies of the single audit reporting package for it to satisfy its report distribution responsibilities under OMB Circular A-133.	_____	_____	_____
<b>F. Overall Conclusions</b>				
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. All federal awards received and expended and the federal programs under which they were received are identified in the entity's accounts.	_____	_____	_____
	b. The entity's internal control over federal programs provides reasonable assurance that it is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its major federal programs.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
c. The entity has complied with laws, regulations, and the provisions of contracts or grant agreements related to each of its major federal programs.	_____	_____	_____
d. The entity has prepared appropriate financial statements, including the schedule of expenditures of federal awards, and completed its sections of the data collection form.	_____	_____	_____
e. The single audit has been properly performed and submitted when due.	_____	_____	_____
f. The entity has followed up on and taken corrective action on audit findings, including preparing a summary schedule of prior audit findings and a corrective action plan.	_____	_____	_____
Except as follows:			
_____			
_____			
_____			
This audit program section has been completed in accordance with firm policy.		Date	
Done by _____		_____	
Reviewed by _____		_____	

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent, and timing of the auditing procedures to be applied in a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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<u>Done</u> <u>by</u>	<u>Date</u>	<u>W/P</u> <u>Ref.</u>
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## XVI. Tests of Compliance Requirements (OMB Circular A-133 Single Audits)

**Note:** The administrative requirements that apply to most federal awards to state and local governmental entities, including public institutions of higher education, arise from two sources: the *Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments* (also known as the A-102 Common Rule) and OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations*, including the agencies' codification of OMB Circular A-110.

States, local governments, and Indian tribal governments are to administer the federal grants and cooperative agreements under the provisions of the A-102 Common Rule, which was codified by each federal funding agency in its volume of the *Code of Federal Regulations* (CFR). Those requirements apply except where they are inconsistent with federal statutes or with regulations authorized in accordance with the exception provision of the A-102 Common Rule. Block grants authorized by the Omnibus Budget Reconciliation Act of 1981 and several other specifically identified programs are exempt from the A-102 Common Rule. (See Appendix I of the May 1998 OMB Circular A-133 *Compliance Supplement* for those exclusions.) In some cases the A-102 Common Rule permits states to follow their own laws and procedures.

The major source of requirements applicable to public institutions of higher education is OMB Circular A-110, which also has been codified in agency regulations. Unlike the A-102 Common Rule, agencies with OMB approval, can modify certain provisions of A-110 to meet their special needs. Circular A-110 also permits federal awarding agencies to apply less restrictive requirements when awarding small awards, except for those requirements that are statutory. Federal awarding agencies also may make exceptions on a case-by-case basis. (Appendix II of the *Compliance Supplement* contains a list of agencies that have codified OMB Circular A-110 and the CFR citations for those codifications.)

Governmental subrecipients are subject to the provisions of the A-102 Common Rule. However, that Rule permits states to impose their own requirements on their governmental subrecipients. Thus, in some circumstances, the auditor may need to refer to state rules and regulations rather than Federal requirements. All public institutions of higher education that are subrecipients, regardless of the type of



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organization making the subaward, are required to follow the provisions of OMB Circular A-110 as implemented by the agency when awarding or administering subgrants except under block grants authorized by the Omnibus Budget Reconciliation Act of 1981 and the Job Training Partnership Act where state rules apply instead.

#### A. Activities Allowed or Unallowed

*Compliance Requirements*—The specific requirements for activities allowed or unallowed are unique to each federal program and are found in the laws, regulations, and provisions of contract or grant agreements pertaining to the program. See Parts 4 and 5 of the *Compliance Supplement* for programs listed therein. This type of compliance requirement specifies the activities that can or cannot be funded under a specific program.

*Audit Objectives*—Determine whether federal awards were expended only for allowable activities.

##### *Audit Procedures*

1. Identify the types of activities that are either specifically allowed or prohibited by the laws, regulations, and provisions of contract or grant agreements pertaining to the program. \_\_\_\_\_
2. When allowability is determined based upon summary level data, perform procedures to verify that: \_\_\_\_\_
  - a. Activities were allowable. \_\_\_\_\_
  - b. Individual transactions were properly classified and accumulated into the activity total. \_\_\_\_\_
3. When allowability is determined based upon individual transactions, select a sample of transactions and perform procedures to verify that the transaction was for an allowable activity. \_\_\_\_\_
4. Determine whether there were large transfers of funds from program accounts that may have been used to fund unallowable activities. \_\_\_\_\_

#### B. Allowable Costs/Cost Principles

**Note:** States, local governments, and Indian tribal governments are subject to the cost principles of OMB Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*. Public institutions of higher education are subject to the cost principles contained in OMB Circular A-21, *Cost Principles for Educational Institutions*. However, for block grants authorized by the Omnibus Budget Reconciliation Act of 1981 and the Job Training Partnership Act, state rules for expenditures of state funds apply. Federal awards administered by publicly-owned hospitals and other providers of medical care are exempt from OMB's cost principles circulars, but are subject to requirements promulgated by the sponsoring Federal agencies (45 CFR part 74, appendix E). The cost principles apply to all federal awards received by the entity, regardless of whether the awards are received directly from the federal government or indirectly through a pass-through entity.

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### *Compliance Requirements—*

#### *General Criteria (Applicable to Both Direct and Indirect Costs)*

- Costs must be reasonable and necessary for the performance and administration of federal awards.
- Costs must be allocable to the federal awards under the provisions of the cost principles. A cost is allocable to a particular cost objective (such as a specific function, program, project, department, or the like) if the goods or services involved are charged or assigned to such cost objective in accordance with relative benefits received.
- Costs must be given consistent treatment through application of those generally accepted accounting principles appropriate to the circumstances. A cost may not be assigned to a federal award as a direct cost if any other cost incurred for the same purpose in like circumstances was allocated to the federal award as an indirect cost.
- Costs must conform to any limitations or exclusions set forth in the circulars, federal laws, state or local laws, sponsored agreements, or other governing regulations as to types or amounts of cost items.
- Costs must be net of all applicable credits that result from transactions that reduce or offset direct or indirect costs. Examples of such transactions include purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments for overpayments or erroneous charges.
- Costs must be documented in accordance with OMB Circular A-110 or the A-102 Common Rule.

#### *Indirect Costs*

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**Note:** See Part 3 of the *Compliance Supplement* for a discussion of the different types of cost allocation plans (CAPs) and indirect cost rate proposal (IDCRPs) and the different types of indirect cost rates.

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- The entity is required to prepare a CAP or IDCRP, as applicable.
- The entity is required to submit the CAP or IDCRP to the federal cognizant agency for indirect cost negotiation for approval, or to maintain the CAP or IDCRP on file for review, as appropriate.

#### *Disclosure Statements*

- If a public institution of higher education received more than \$25 million in federal funding in a fiscal year, it is required to maintain an accurate DS-2 that describes its cost accounting practices and to comply with the disclosed cost accounting practices.

**Audit Objectives—**Determine whether the organization complied with the provisions of the applicable OMB cost principles circulars (OMB Circulars A-87 or A-21) as follows:

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<ul style="list-style-type: none"> <li>• Direct charges to federal awards were for allowable costs.</li> <li>• Charges to cost pools used in calculating indirect cost rates were for allowable costs.</li> <li>• For states, local governments, and Indian tribal governments, charges to cost pools allocated to federal awards though CAPs were for allowable costs.</li> <li>• The methods of allocating the costs are in accordance with the applicable cost principles and produce an equitable and consistent distribution of costs (such as, cost allocation bases include all allowable and unallowable base costs to which allowable indirect costs are allocable and the cost allocation methodology complies with the applicable cost principles and provides equitable and consistent allocation of indirect costs to benefiting cost objectives).</li> <li>• Indirect cost rates were applied in accordance with approved rate agreements and associated billings were the result of applying the approved rate to the proper base amount(s).</li> <li>• For entities covered by OMB Circular A-87, cost allocations were in accordance with CAPs approved by the federal cognizant agency for indirect cost negotiation or, in cases where such plans are not subject to approval, in accordance with the plan on file.</li> <li>• Cost accounting practice disclosures, described in the DS-2 (including amendments), represented actual practice consistently applied. (This objective only applies to those public institutions of higher education that are required to submit the DS-2.)</li> </ul>			

#### *Audit Procedures*

1. Test a sample of transactions (for both direct and indirect costs) to determine that the costs:
  - a. For state and local governments, are authorized or not prohibited under state or local laws or regulations.
  - b. Are approved by the federal awarding agency, if required.
  - c. Conform with the allowability of costs provisions of applicable cost principles, or limitations in the program agreement, program regulations, or program statute.
  - d. Conform with the allocability provisions of applicable cost principles.
  - e. Represent charges for actual costs, not budgeted or projected amounts.
  - f. Allocated or charged for fringe benefits are based on the benefits received by different classes of employees within the organization.
  - g. Are applied uniformly to federal and non-federal activities.
  - h. Are given consistent accounting treatment within and between accounting periods.

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
i. Are calculated in conformity with generally accepted accounting principles or another comprehensive basis of accounting when so required under the applicable cost principles. (Note that costs for post-employment benefits must be funded to be allowable.)	_____	_____	_____
j. Are not included as a cost or used to meet cost sharing requirements of other federally-supported activities of the current or a prior period.	_____	_____	_____
k. Are net of all applicable credits.	_____	_____	_____
l. Are not included as both a direct billing and as a component of indirect costs (that is, the costs are excluded from cost pools included in CAPs or IDCPRs, if they are charged directly to federal awards).	_____	_____	_____
m. Are supported by appropriate documentation (such as approved purchase orders, receiving reports, vendor invoices, canceled checks, and time and attendance records) and correctly charged as to account, amount, and period.	_____	_____	_____
n. If any unallowable costs have been identified, determine whether there are any directly associated costs that also may have been charged and that also are unallowable. (Directly associated costs are costs incurred solely as a result of incurring another cost, and would not have been incurred if the other cost had not been incurred. For example, fringe benefits are directly associated with payroll costs.)	_____	_____	_____
2. When material charges are made from internal service, central service, pension, or similar activities or funds, verify that the charges from those activities or funds are in accordance with the applicable cost principles by performing the following:			
a. For activities accounted for in separate funds, determine whether:			
(1) Retained earnings/fund balances (including reserves) were computed in accordance with the applicable cost principles.	_____	_____	_____
(2) Working capital was not excessive in amount (generally not greater than sixty days for cash expenses for normal operations incurred for the period exclusive of depreciation, capital costs, and debt principal costs).	_____	_____	_____
(3) Refunds were made to the federal government for its share of any amounts transferred or borrowed from internal service or central service funds for purposes other than to meet the operating liabilities, including interest on debt, of the fund.	_____	_____	_____
b. Test that all users of services are billed in a consistent manner.	_____	_____	_____
c. Test that billing rates exclude unallowable costs, in accordance with applicable cost principles.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
d. Test, where activities are not accounted for in separate funds, that billing rates (or charges) are developed based on actual costs and were adjusted to eliminate profits.	_____	_____	_____
e. For organizations that have self-insurance and a certain type of fringe benefit programs (such as pension funds), determine whether independent actuarial studies appropriate for such activities are performed at least biennially and that current period costs were allocated based on an appropriate study that is not over two years old.	_____	_____	_____
3. When material charges are made to a major program based on an IDCPR, determine whether the IDCPR was tested in a prior year.			
a. When testing of the IDCPR performed in a prior year provides appropriate audit assurance, inquire of management whether any changes have been made to the cost accounting practices and the likely effect of those changes.	_____	_____	_____
b. If changes in cost accounting practices are material, and the entity is required to file the IDCPR with a federal cognizant agency for indirect cost negotiation, determine whether the entity notified the federal agency of the changes in cost accounting practices.	_____	_____	_____
4. Perform the following tests when material charges are made to a major program based on a CAP or on an IDCPR for which prior testing does not provide appropriate audit assurance (such as when prior testing was not performed), or when material charges are expected to be made to a major program in future years based on an IDCPR:			
a. Test the cost pools that form the basis of the IDCPR or CAP and the resulting charges to federal awards to determine whether they include only allowable costs in accordance with the cost principles. (See audit procedure 1 above.)	_____	_____	_____
b. Test the methods of allocating the costs to determine whether they comply with the provisions of the cost principles and produce an equitable distribution of costs. Appropriate detailed tests may include:			
(1) Test statistical data (such as square footage, case counts, salaries and wages) to determine whether the proposed allocation or rate bases are reasonable, updated as necessary, and do not contain any material omissions.	_____	_____	_____
(2) Review time studies or time and effort reports (where and if used) to determine whether they 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
(3) Review the allocation methodology for consistency and test the appropriateness of methods used to make changes.	_____	_____	_____
5. Perform the following procedures to test the application of charges to federal awards based upon an indirect cost rate agreement (IDCRA) or a CAP.			
a. Determine whether material indirect costs or centralized or administrative services costs were allocated or charged to a major program. If not, the following audit procedures b through e do not apply.	_____	_____	_____
b. Obtain and read the current IDCRA or CAP and determine the terms in effect.	_____	_____	_____
c. For IDCRA's, select a sample of claims for reimbursement and determine whether the rates used are in accordance with the rate agreement, whether rates were applied to the appropriate bases, and whether the amounts claimed were the product of applying the rate to the applicable base. Determine whether the costs included in the base(s) are consistent with the costs that were included in the base year (for example, if the allocation base is total direct costs, verify that current year direct costs do not include costs items that were treated as indirect costs in the base year).	_____	_____	_____
d. For public assistance CAPs, determine whether the methods of charging costs to federal awards are in accordance with the provisions of the approved CAP or prepared CAP on file.	_____	_____	_____
e. For state and local government-wide CAPs, determine whether the amounts used for reimbursement of central service costs for federal awards were in accordance with the approved CAPs or prepared CAP on file.	_____	_____	_____
6. Perform the following procedures for the DS-2:			
a. Read the DS-2 and its amendments and determine whether the disclosures agree with the policies prescribed in the entity's policies and procedures documents.	_____	_____	_____
b. Test that the disclosures agree with actual practices for the period covered by audit, including whether the practices were consistent throughout the period.	_____	_____	_____

C. Cash Management

*Compliance Requirements*

- When entities are funded on a reimbursement basis, program costs must be paid for by entity funds before reimbursement is requested from the federal government.
- When funds are advanced, recipients must follow procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<ul style="list-style-type: none"> <li>When advance payment procedures are used, recipients must establish similar procedures for subrecipients. Pass-through entities must establish reasonable procedures to ensure receipt of reports on subrecipients' cash balances and cash disbursements in sufficient time to enable the pass-through entities to submit complete and accurate cash transactions reports to the federal awarding agency or pass-through entity. Pass-through entities must monitor cash drawdowns by their subrecipients to assure that subrecipients conform substantially to the same standards of timing and amount as apply to the pass-through entity.</li> <li>Interest earned on advances by local government grantees and subgrantees is required to be submitted promptly, but at least quarterly, to the federal agency. Up to \$100 per year may be kept for administrative expenses.</li> <li>Interest earned by non-state public institutions of higher education on federal fund balances in excess of \$250 is required to be remitted to the Department of Health and Human Services.</li> <li>Treasury regulations at 31 CFR part 205 (which implement the Cash Management Improvement Act of 1990) require state recipients to enter into Treasury-State agreements that prescribe specific methods of drawing down federal funds for selected large programs, including the length of time for advancing funds before expenditure (three days or less) and the terms and conditions under which an interest liability would be incurred. Programs not covered by a Treasury-State agreement are subject to default procedures prescribed by Treasury in Subpart B of 31 CFR part 205.</li> <li>The requirements for cash management are contained in OMB Circular 102 (paragraph 2.a.), the A-102 Common Rule (section .21), OMB Circular A-110 (section .22), Treasury regulations at 31 CFR part 205, federal awarding agency regulations, and the terms and conditions of the award.</li> </ul>			

#### *Audit Objectives*

- If the entity is not a state, determine whether it followed procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury, or pass-through entity, and their disbursement.
- If the entity is a state, determine whether it complied with the terms and conditions of the Treasury-State agreement or default procedures prescribed by Treasury.
- If the entity is a pass-through entity, determine whether it implemented procedures to assure that subrecipients conformed substantially to the same timing requirements that apply to the pass-through entity.
- Determine whether interest earned on advances was reported/remitted as required.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<i>Audit Procedures</i>			
1. Select a sample of advances of federal funds and compare to the dates the funds were disbursed and/or checks were presented to the banks for payments. Using these data, determine whether:			
a. For states, the timing of disbursements were in compliance with the Treasury-State agreement or default procedures, whichever is applicable.	_____	_____	_____
b. For advances to other recipients and subrecipients, established procedures to minimize the time elapsing between drawdown and disbursement were followed.	_____	_____	_____
2. Where applicable, select a sample of reimbursement requests and trace to supporting documentation showing that the costs for which reimbursement was requested were paid prior to the date of the reimbursement request.	_____	_____	_____
3. For audits of states, review the calculation of the interest obligation owed to or by the federal government reported on the annual report submitted by the state to determine whether the calculation was in accordance with Treasury regulations and the terms of the Treasury-State agreement or default procedures. Trace amounts used in the calculation to supporting documentation.	_____	_____	_____
4. For audits of other entities, review records to determine if interest was earned on advances. If so, review evidence to determine whether it was returned to the appropriate agency.	_____	_____	_____

#### D. Davis-Bacon Act

*Compliance Requirements*—When required by the Davis Bacon Act, the Department of Labor's (DOL) governmentwide implementation of the Davis-Bacon Act, or by federal program legislation, all laborers and mechanics employed by contractors or subcontractors to work on construction contracts in excess of \$2,000 financed by federal awards must be paid wages not less than those established for the locality of the project (prevailing wage rates) by the DOL.

*Audit Objective*—Determine whether the entity ensured that contractors and subcontractors paid prevailing wage rates for projects covered by the Davis-Bacon Act.

#### *Audit Procedures*

- |  |       |       |       |
|--|-------|-------|-------|
| 1. Determine whether the entity receives federal funds for construction projects; if so, review program/project requirements to determine whether the program/project is covered by the Davis-Bacon Act. | _____ | _____ | _____ |
| 2. Select a sample of construction contracts and subcontracts and verify that the required prevailing wage rate clauses were included in contracts for construction which exceed \$2,000.                | _____ | _____ | _____ |



	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
3. Determine the prevailing wage rates applicable at the time of the construction payroll.	_____	_____	_____
4. Examine a sample of contractor or subcontractor payroll submissions and certifications and determine whether such submissions indicate that laborers and mechanics were paid the prevailing wage rates established by the DOL for the locality at the time of the construction payroll.	_____	_____	_____

#### E. Eligibility

*Compliance Requirements*—The specific requirements for eligibility are unique to each federal program and are found in the laws, regulations, and provisions of contract or grant agreements pertaining to the program. See Parts 4 and 5 of the *Compliance Supplement* for programs listed therein. This type of compliance requirement specifies the criteria for determining the individuals, groups of individuals, or subrecipients that can participate in the program and the amounts for which they qualify.

##### *Audit Objectives*

- Determine whether required eligibility determinations were made, (including obtaining any required documentation/verifications) and that individual program participants or groups of participants (including area of service delivery) were determined to be eligible and participated in the program.
- Determine whether subawards were made only to eligible subrecipients.
- Determine whether amounts provided to or on behalf of eligibles were calculated in accordance with program requirements.

##### *Audit Procedures*<sup>1</sup>

- |  |       |       |       |
|--|-------|-------|-------|
| 1. Perform procedures to determine whether the entity's records/database includes all individuals receiving benefits during the audit period (that is, that the population of individuals receiving benefits is complete). | _____ | _____ | _____ |
| 2. Select a sample of individuals receiving benefits and perform tests to determine whether:   |       |       |       |
| a. The entity performed the required determination of initial eligibility (including obtaining any required documentation and verifications) and the individual was appropriately determined to be eligible.               | _____ | _____ | _____ |

<sup>1</sup> For some federal programs with a large number of people receiving benefits, the entity may use a computer system for processing individual eligibility determinations and delivery of benefits. Often these computer systems are complex and will be separate from the entity's regular financial accounting system. When eligibility is material to a major program, and a computer system is integral to eligibility compliance, the auditor should follow the guidance of SAS No. 80 (AU Section 326) and consider the entity's computer processing and perform audit procedures relative to the computer system for eligibility as necessary to support the opinion on compliance for the major program.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
b. The entity performed the required determination of continuing eligibility (including obtaining any required documentation and verifications) and the individual was appropriately determined to be eligible.	_____	_____	_____
c. Benefits paid to or on behalf of the individuals were calculated correctly and in compliance with the requirements of the program.	_____	_____	_____
d. Benefits were discontinued when the period of eligibility expired.	_____	_____	_____
3. Review the entity's quality control process (if one is required by the program) and perform tests to determine whether it is operating effectively to meet the objectives of the process and in compliance with applicable program requirements.	_____	_____	_____
4. For those programs for which a population or area of service delivery needs to be eligible, perform tests to determine whether:			
a. The population or area served was eligible.	_____	_____	_____
b. The benefits paid to or on behalf of the individuals or area of service delivery were calculated correctly.	_____	_____	_____
5. For those programs that use subrecipients:			
a. If the determination of eligibility is based upon an approved application or plan, obtain a copy of that document and identify the applicable eligibility requirements.	_____	_____	_____
b. Select a sample of the awards to subrecipients and perform procedures to determine whether the subrecipients were eligible and amounts awarded were within funding limits.	_____	_____	_____

#### F. Equipment<sup>2</sup> and Real Property Management

##### *Compliance Requirements*

- Title to equipment acquired by a non-federal entity with federal awards vests with the non-federal entity.
- A state is required to use, manage, and dispose of equipment acquired under a federal grant in accordance with state laws and procedures.
- Subrecipients of states that are local governments or Indian tribal governments are required to use state laws and procedures for equipment acquired under a subgrant from a state.
- For equipment acquired under federal awards received directly from a federal awarding agency, local governments and Indian tribal governments are required to follow the A-102 Common Rule and public institutions of higher education are required to follow the provisions of OMB Circular A-110. Those rules require that equipment be used in the program that acquired it or, when

<sup>2</sup> Equipment means tangible nonexpendable property, including exempt property, charged directly to a federal award having a useful life of more than one year and an acquisition cost of \$5,000 or more per unit. However, consistent with a non-federal entity's policy, lower limits may be established.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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appropriate, other federal programs. The recipient also is required to maintain equipment records, take a physical inventory of equipment at least once every two years and reconcile it to the equipment records, institute an appropriate control system to safeguard equipment, and adequately maintain equipment. When equipment with a current per unit fair market value in excess of \$5,000 is no longer needed for a federal program, it may be retained or sold with the federal agency having a right to a proportionate amount of the current fair market value. Proper sales procedures are required to be used that provide for competition to the extent practicable and result in the highest possible return.

- The requirements for equipment are contained in the A-102 Common Rule (section .32), OMB Circular A-110 (section .34), federal awarding agency program regulations, and the terms and conditions of the award.
- Title to real property acquired by non-federal entities with federal awards vests with the non-federal entity.
- Real property acquired by non-federal entities with federal awards is to be used for the originally authorized purpose as long as needed for that purpose. For public institutions of higher education, the real property may be used in other federally-sponsored projects or programs that have purposes consistent with those authorized for support by the federal awarding agency if written approval is given by the federal awarding agency. The non-federal entity may not dispose of or encumber the title to real property without the prior consent of the awarding agency.
- When real property is no longer needed for the federally-supported programs or projects, the non-federal entity is to request disposition instructions from the awarding agency. When real property is sold, sales procedures should provide for competition to the extent practicable and result in the highest possible return. If the real property is sold, the non-federal entity is normally required to remit to the awarding agency the federal portion of net sales proceeds. If the real property is retained, the non-federal entity is normally required to compensate the awarding agency for the federal portion of the current fair market value of the property. Disposition instructions may also provide for transfer of title to the federal government; if this happens, the non-federal entity is entitled to compensation for its percentage share of the current fair market value.
- The requirements for real property are contained in the A-102 Common Rule (section .31), OMB Circular A-110 (section .32), federal awarding agency regulations, and the terms and conditions of the award.

#### *Audit Objectives*

- Determine whether the entity maintains proper records for equipment and adequately safeguards and maintains equipment.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<ul style="list-style-type: none"> <li>Determine whether the disposition or encumbrance of any equipment or real property acquired under federal awards is in accordance with federal requirements and that the awarding agency was compensated for its share of any property sold or converted to non-federal use.</li> </ul>			
<i>Audit Procedures</i>			
<i>(Procedures 1 and 2 only apply to subrecipients of states that are local governments or Indian tribal governments.)</i>			
1. Obtain the entity's policies and procedures for equipment management and determine whether they comply with the state's policies and procedures.	_____	_____	_____
2. Select a sample of equipment transactions and test for compliance with the state's policies and procedures for management and disposition of equipment.	_____	_____	_____
<i>(Procedures 3-8 only apply to public institutions of higher education and federal awards received directly from a federal awarding agency by a local government or an Indian tribal government.)</i>			
3. Inquire if a required physical inventory of equipment acquired under federal awards was taken within the last two years. Test whether any differences between the physical inventory and equipment records were resolved.	_____	_____	_____
4. Identify equipment acquired under federal awards during the audit period and trace selected purchases to the property records. Verify that the property records contain the following information about the equipment: description (including serial number or other identification number), source, who holds title, acquisition date and cost, percentage of federal participation in the cost, location, condition, and, if applicable, any ultimate disposition data including, the date of disposal and sales price or method used to determine current fair market value.	_____	_____	_____
5. Select a sample of equipment identified as acquired under federal awards from the property records and physically inspect the equipment including whether the equipment is appropriately safeguarded and maintained.	_____	_____	_____
6. Determine the amount of equipment dispositions for the audit period and perform procedures to verify that dispositions were properly classified between equipment acquired under federal awards and equipment otherwise acquired.	_____	_____	_____
7. For dispositions of equipment acquired under federal awards, perform procedures to verify that the dispositions were properly reflected in the property records.	_____	_____	_____
8. For dispositions of equipment acquired under federal awards with a current per-unit fair market value in excess of \$5000, test whether the awarding agency was reimbursed for the appropriate federal share.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<i>(Procedures 9-10 apply to states, local governments, and Indian tribal governments regardless of whether funding is received as a recipient or subrecipient.)</i>			
9. Determine real property dispositions for the audit period and whether such real property was acquired with federal awards.	_____	_____	_____
10. For dispositions of real property acquired under federal awards, perform procedures to verify that the entity followed the instructions of the awarding agency, which will normally require reimbursement to the awarding agency for the federal portion of net sales or fair market value at the time of disposition, as applicable.	_____	_____	_____

### G. Matching, Level of Effort, Earmarking

*Compliance Requirements*—Except as discussed below, the specific requirements for Matching, Level of Effort, and Earmarking are unique to each federal program and are found in the laws, regulations, and provisions of contract or grant agreements pertaining to the program. See Parts 4 and 5 of the *Compliance Supplement* for programs listed therein. Matching, level of effort and earmarking are defined as follows:

- *Matching or cost sharing* includes requirements to provide contributions (usually non-federal) of a specified amount or percentage to match federal awards. Matching may be in the form of allowable costs incurred or in-kind contributions (including third-party in-kind contributions).
- *Level of effort* includes requirements for (a) a specified level of service to be provided from period to period, (b) a specified level of expenditures from non-federal or federal sources for specified activities to be maintained from period to period, and (c) federal funds to supplement and not supplant non-federal funding of services.
- *Earmarking* includes requirements that specify the minimum and/or maximum amount or percentage of the program's funding that must/may be used for specified activities, including funds provided to subrecipients. Earmarking may also be specified in relation to the types of participants covered.

*For matching, the A-102 Common Rule and OMB Circular A-110 provide the following detailed criteria for acceptable costs and contributions. They should be:*

- Verifiable from the non-federal entity's records.
- Not included as contributions for any other federally-assisted project or program, unless specifically allowed by federal program laws and regulations.
- Necessary and reasonable for proper and efficient accomplishment of project or program objectives.
- Allowed under the applicable cost principles.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
• Not paid by the federal government under another award, except where authorized by federal statute to be allowable for cost sharing or matching.			
• Provided for in the approved budget when required by the federal awarding agency.			
• In conformity with other applicable provisions of the A-102 Common Rule and OMB Circular A-110 and the laws, regulations, and provisions of contract or grant agreements applicable to the program.			

#### *Audit Objectives*

- *Matching*—Determine whether the minimum amount or percentage of contributions or matching funds was provided.
- *Level of Effort*—Determine whether specified service or expenditure levels were maintained.
- *Earmarking*—Determine whether minimum or maximum limits for specified purposes or types of participants were met.

#### *Audit Procedures*

1. For matching compliance requirements:			
a. Perform tests to verify that the required matching contributions were met.	_____	_____	_____
b. Determine the sources of matching contributions and perform tests to verify that they were from an allowable source.	_____	_____	_____
c. Test records to corroborate that the values placed on in-kind contributions (including third party in-kind contributions) are in accordance with the OMB cost principles circulars, the A-102 Common Rule, OMB Circular A-110, program regulations, and the terms of the award.	_____	_____	_____
d. Test transactions used to match for compliance with the allowable costs/cost principles requirement.	_____	_____	_____
2. For level of effort compliance requirements:			
a. Identify the required level of effort and perform tests to verify that the level of effort requirement was met.	_____	_____	_____
b. Perform test to verify that only allowable categories of expenditures or other effort indicators (such as hours or number of people served) were included in the computation and that the categories were consistent from year to year. For example, in some programs, capital expenditures may not be included in the computation.	_____	_____	_____
c. Perform procedures to verify that the amounts used in the computation were derived from the books and records from which the audited financial statements were prepared.	_____	_____	_____
d. Perform procedures to verify that non-monetary effort indicators were supported by official records.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
e. Determine whether the entity used federal funds to provide services that they were required to make available under federal, state, or local law and were also made available by funds subject to a supplement not supplant requirement.	_____	_____	_____
f. Determine whether the entity used federal funds to provide services that were provided with non-federal funds in the prior year.			
(1) Identify the federally-funded services.	_____	_____	_____
(2) Perform procedures to determine whether the federal program funded services that were previously provided with non-federal funds.	_____	_____	_____
(3) Perform procedures to determine whether the total level of services applicable to the requirement increased in proportion to the level of federal contribution.	_____	_____	_____
3. For earmarking compliance requirements:			
a. Identify the applicable percentage or dollar requirements for earmarking.	_____	_____	_____
b. Perform procedures to verify that the amounts recorded in the financial records met the requirements (for example, when a minimum amount is required to be spent for a specified type of service, perform procedures to verify that the financial records show that at least the minimum amount for this type of service was charged to the program; or, when the amount spent on a specified type of service may not exceed a maximum amount, perform procedures to verify that the financial records show no more than this maximum amount for the specified type of service was charged to the program).	_____	_____	_____
c. When earmarking requirements specify a minimum percentage or amount, select a sample of transactions supporting the specified amount or percentage and perform tests to verify proper classification to meet the minimum percentage or amount.	_____	_____	_____
d. When the earmarking requirements specify a maximum percentage or amount, review the financial records to identify whether transactions for the specified activity were improperly classified in another account (for example, if only ten percent may be spent for administrative costs, review accounts for other than administrative costs to identify whether administrative costs were improperly classified elsewhere and thereby cause the maximum percentage or amount to be exceeded).	_____	_____	_____
e. When earmarking requirements prescribe the minimum number or percentage of specified types of participants that can be served, select a sample of participants that are counted toward meeting the minimum requirement and perform tests to verify that they were properly classified.	_____	_____	_____

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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- f. When earmarking requirements prescribe the maximum number or percentage of specified types of participants that can be served, select a sample of other participants and perform tests to verify that they were not of the specified type.

_____	_____	_____
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#### H. Period of Availability of Federal Funds

**Compliance Requirements**—Federal awards may specify a time period during which the non-federal entity may use the federal funds. Where a funding period is specified, a non-federal entity may charge to the award only costs resulting from obligations incurred during the funding period and any pre-award costs authorized by the federal awarding agency. Also, if authorized by the federal program, unobligated balances may be carried over and charged for obligations of the subsequent funding period. Obligations means the amounts of orders placed, contracts and subgrants awarded, goods and services received, and similar transactions during a given period that will require payment by the non-federal entity during the same or a future period. Non-federal entities subject to the A-102 Common Rule are required to liquidate all obligations incurred under the award not later than ninety days after the end of the funding period (or as specified in a program regulation) to coincide with the submission of the annual Financial Status report (SF-269). The federal agency may extend this deadline upon request.

**Audit Objective**—Determine whether federal funds were obligated within the period of availability and obligations were liquidated within the required time period.

##### *Audit Procedures*

1. Review the award documents and regulations pertaining to the program and determine any award-specific requirements related to the period of availability and document the availability period.
2. Test a sample of transactions charged to the federal award after the end of the period of availability and verify that the underlying obligations occurred within the period of availability and that the liquidation (payment) was made within the allowed time period.
3. Test a sample of transactions that were recorded during the period of availability and verify that the underlying obligations occurred within the period of availability.
4. Select a sample of adjustments to the federal funds and verify that those adjustments were for transactions that occurred during the period of availability.

_____	_____	_____
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_____	_____	_____
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<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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## I. Procurement and Suspension and Debarment

### *Compliance Requirements—*

#### *Procurement*

- States and governmental subrecipients of states are to use the same policies and procedures used for procurements from non-federal funds. They also are to ensure that every purchase order or other contract includes any clauses required by federal statutes and executive orders and their implementing regulations.
- Local governments and Indian tribal governments that are not subrecipients of states are to use their own procurement procedures provided that they conform to applicable federal law and regulations and standards identified in the A-102 Common Rule.
- Public institutions of higher education are to use procurement procedures that conform to applicable federal law and regulations and standards identified in OMB Circular A-110.
- All non-federal entities are to follow federal laws and implementing regulations applicable to procurements, as noted in federal agency implementation of the A-102 Common Rule and OMB Circular A-110.
- Requirements for procurement are contained in the A-102 Common Rule (section .36), OMB Circular A-110 (sections .40–.48), federal awarding agency regulations, and the terms of the award.

#### *Suspension and Debarment*

- Non-federal entities are prohibited from contracting with or making subawards under covered transactions to parties that are suspended or debarred or whose principals are suspended or debarred. Covered transactions include procurement contracts for goods or services equal to or in excess of \$100,000 and all nonprocurement transactions (such as subawards to subrecipients).
- Contractors receiving individual awards for \$100,000 or more and all subrecipients must certify that the organization and its principals are not suspended or debarred. The non-federal entities may rely upon the certification unless it knows that the certification is erroneous.

#### *Audit Objectives*

- Determine whether procurements were made in compliance with the provisions of the A-102 Common Rule, OMB Circular A-110, and other procurement requirements specific to an award.
- Determine whether the entity obtained the required certifications for covered contracts and subawards.

*Audit Procedures*

*(Procedures 1–4 apply only to public institutions of higher education and federal awards received directly from a federal awarding agency by a local government or an Indian tribal government.)*

1. Obtain the entity's procurement policies. Verify that the policies comply with applicable federal requirements.
2. Determine whether the entity has a policy to use statutorily or administratively-imposed in-state or local geographical preferences in the evaluation of bids or proposals. If yes, verify that these limitations were not applied to federal procurements except where applicable federal statutes expressly mandate or encourage geographic preference.
3. Examine procurement policies and procedures and verify the following:
  - a. Written selection procedures require that solicitations incorporate a clear and accurate description of the technical requirements for the material, product, or service to be procured, identify all requirements that the offerors must fulfill, and include all other factors to be used in evaluating bids or proposals.
  - b. There is a written policy pertaining to ethical conduct.
4. Select a sample of procurements and perform the following:
  - a. Examine contract files and verify that they document the significant history of the procurement, including the rationale for the method of procurement, selection of contract type, contractor selection or rejection, and the basis of contract price.
  - b. Verify that procurements provide full and open competition.
  - c. Examine documentation in support of the rationale to limit competition in those cases where competition was limited and determine whether the limitation was justified.
  - d. Verify that contract files exist and determine whether appropriate cost or price analysis was performed in connection with procurement actions, including contract modifications and that this analysis supported the procurement action.
  - e. Verify that the awarding federal agency approved procurements exceeding \$100,000 when such approval was required. Prior federal awarding agency approval may be required for procurements (1) awarded by noncompetitive negotiation, (2) awarded when only a single bid or offer was received, (3) awarded to other than the apparent low bidder, or (4) specifying a "brand name" product.
  - f. Verify compliance with other procurement requirements specific to an award.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
_____	_____	_____
_____	_____	_____
_____	_____	_____
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_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<i>(Procedure 5 only applies to states and federal awards subgranted by a state to a local government or Indian tribal government.)</i>			
5. Test a sample of procurements to determine whether the state's laws and procedures were followed and that the policies and procedures used were the same as for state funds.	_____	_____	_____
<i>(Procedures 6 applies to all non-federal entities)</i>			
6. Test a sample of procurements and subawards and determine whether the required suspension and debarment certifications were received for subawards and covered contracts. Alternatively, the auditor may test a sample of procurements and subawards to the <i>List of Parties Excluded From Federal Procurement or Nonprocurement Programs</i> issued by the General Services Administration and determine whether contracts were awarded to suspended or debarred parties.	_____	_____	_____

## J. Program Income

### *Compliance Requirements*

- Program income is gross income received that is directly generated by the federally-funded project during the grant period. If authorized by federal regulations or the grant agreement, costs incident to the generation of program income may be deducted from gross income to determine program income. Program income includes, but is not limited to, income from fees for services performed, the use or rental of real or personal property acquired with grant funds, the sale of commodities or items fabricated under a grant agreement, and payments of principal and interest on loans made with grant funds. Except as otherwise provided in the federal awarding agency regulations or terms and conditions of the award, program income does not include interest on grant funds (covered under Cash Management), rebates, credits, discounts, refunds, and so forth (covered under Allowable Costs/Cost Principles), or interest earned on any of them (covered under Cash Management). Program income does not include the proceeds from the sale of equipment or real property (covered under Equipment and Real Property Management).
- Program income may be used in one of three methods: deducted from outlays, added to the project budget, or used to meet matching requirements. Unless specified in the federal awarding agency regulations or the terms and conditions of the award, program income is required to be deducted from program outlays. However, for research and development activities by public institutions of higher education, the default method is to add program income to the project budget. Unless federal awarding agency regulations or the terms and conditions of the award specify otherwise, non-federal entities have no obligation to the federal government regarding program income earned after the end of the grant period.

- The requirements for program income are found in the A-102 Common Rule (section .25), OMB Circular A-110 (section .2 (program income definition) and section .24), federal awarding agency laws, program regulations, and the provisions of the contract or grant agreements pertaining to the program.

*Audit Objective*—Determine whether program income is correctly recorded and used in accordance with the program requirements, A-102 Common Rule, and OMB Circular A-110, as applicable.

*Audit Procedures*

1. Review the laws, regulations, and provisions of contract or grant agreements applicable to the program and determine whether program income was anticipated and, if so, the requirements for recording and using program income.
2. Inquire of management and review accounting records to determine whether program income was received.
3. Perform tests to verify that all program income was properly recorded in the accounting records.
4. Perform tests to determine whether program income was used in accordance with the program requirements, the A-102 Common Rule, and OMB Circular A-110.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

## K. Real Property Acquisition and Relocation Assistance

*Compliance Requirements*

- The Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970, as amended (URA), provides for uniform and equitable treatment of persons displaced by federally-assisted programs from their homes, businesses, or farms. Property acquired must be appraised by qualified independent appraisers. All appraisals must be examined by a review appraiser to assure acceptability. After acceptance, the review appraiser certifies the recommended or approved value of the property for establishment of the offer of just compensation to the owner. Federal requirements govern the determination of payments for replacement housing assistance, rental assistance, and down payment assistance for individuals displaced by federally-funded projects. The regulations also cover the payment of moving-related expenses and reestablishment expenses incurred by displaced businesses and farm operations.
- Government-wide requirements for real property acquisition and relocation assistance are contained in Department of Transportation's single governmentwide rule at 49 CFR part 24, Uniform Relocation Assistance and Real Property Acquisition Regulations for Federal and Federally-Assisted Programs.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<i>Audit Objective</i> —Determine whether the non-federal entity complied with the real property acquisition, appraisal, negotiation, and relocation requirements.			
<i>Audit Procedures</i>			
1. Inquire of management and review the records of federal programs to determine whether the non-federal entity administers federally-assisted programs that involve the acquisition of real property or the displacement of households or businesses.	_____	_____	_____
2. For a sample of property acquisitions:			
a. Test records to determine whether: (1) the just compensation amount offered the property owner was determined by an appraisal process; (2) the appraisal(s) was examined by a review appraiser; and (3) the review appraiser prepared a signed statement that explains the basis for adjusting comparable sales to reach the review appraiser's determination of the fair market value.	_____	_____	_____
b. Test supporting documentation to determine whether: (1) a written offer of the appraised value was made to the property owner; and (2) a written justification was prepared if the purchase price for the property exceeded the amount offered and that the documentation (such as recent court awards, estimated trial costs, valuation problems) supports such administrative settlement as being reasonable, prudent, and in the public interest.	_____	_____	_____
c. Test supporting documentation for residential relocations to determine whether the entity made available one or more comparable replacement dwellings to the displaced persons.	_____	_____	_____
3. For a sample of replacement housing payments, test the entity's records to determine whether there is documentation that supports the following:			
a. The owner occupied the displacement dwelling for at least 180 days immediately prior to initiation of negotiations.	_____	_____	_____
b. The entity examined at least three comparable replacement dwellings available for sale and computed the payment on the basis of the price of the dwelling most representative of the displacement dwelling.	_____	_____	_____
c. The asking price for the comparable dwelling was adjusted, to the extent justified by local market data, to recognize local area selling price reductions.	_____	_____	_____
d. The allowance for increased mortgage cost "buy down" amount was computed based on the remaining principal balance, the interest rate, and the remaining term of the old mortgage on the displacement dwelling.	_____	_____	_____

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e. The entity prepared written justification on the need to employ last resort housing provisions if the total replacement housing payment exceeded \$22,500.	_____	_____	_____
4. For a sample of rental and downpayment assistance, test the entity's records to determine whether there is documentation that supports the following:			
a. The displacee occupied the displacement dwelling for at least ninety days immediately prior to initiation of negotiations.	_____	_____	_____
b. The displacee rented, or purchased, and occupied a decent, safe, and sanitary replacement dwelling within one year.	_____	_____	_____
c. The entity prepared written justification if the payment exceeded \$5,250.	_____	_____	_____
5. For a sample of business relocations:			
a. Test that payments for moving and related expenses were for actual costs incurred or that fixed payments, in lieu of actual costs, were limited to a maximum of \$20,000 and computed based on the average annual net earnings of the business as evidenced by income tax returns, certified financial statements, or other reliable evidence.	_____	_____	_____
b. For business reestablishment expenses, verify that (1) the displacee was eligible as a farm operation, a non-profit organization, or a small business to receive reestablishment assistance, and (2) the payment was for actual costs incurred and did not exceed \$10,000.	_____	_____	_____

## L. Reporting

### *Compliance Requirements*

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**Note:** See also Parts 4 and 5 of the *Compliance Supplement* for programs listed therein.

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**Financial Reporting**—Recipients should use the standard financial reporting forms or such other forms as may be authorized by OMB. Those other forms may include financial, performance, and special reporting. Each recipient must report program outlays and program income on a cash or accrual basis, as prescribed by the federal awarding agency. The awarding agency may accept identical information from the recipient in machine-readable format, computer printouts, or electronic outputs in lieu of the prescribed formats. (The open-ended entitlement programs shown in Appendix I of the *Compliance Supplement* require quarterly reports.) The reporting requirements for subrecipients are as specified by the pass-through entity. In many cases, these will be the same as or similar to the following

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requirements for recipients. The standard financial reporting forms are described in Part 3 of the *Compliance Supplement*. Financial reporting requirements are contained in the A-102 Common Rule (section .41), OMB Circular A-110 (section .52), and the laws, regulations, and the provisions of contract or grant agreements pertaining to the program.

*Reporting Under the Payment Management System*—Many recipients use the Payment Management System (PMS) operated by the Division of Payment Management (DPM) of the Department of Health and Human Services. Once a quarter, using the authorization amounts provided by the federal agency, payments requested by recipients, cash collection activity, and disbursement information provided by recipients, DPM generates PMS 272 reports, which are either mailed to the recipient or electronically downloaded by the recipient using DPM's Electronic 272 System. (The PMS 272 series of reports are described in Part 3 of the *Compliance Supplement*.) Recipients should verify the reported amounts. If discrepancies are noted, the report is annotated (or the PMS 272-C is completed) and returned to DPM. The recipient uses the PMS 272-A to report the amount of disbursements made; then signs, dates, and returns the report to DPM. Recipients may report disbursements data electronically using the Electronic 272 process. PMS 272 reporting requirements do not apply to block grant programs; however, DPM does provide block grant recipients with quarterly report, which is provided solely for information and no action is required by the recipient.

*Performance Reporting*—Recipients are required to submit performance reports at least annually but not more frequently than quarterly. Performance reports generally contain, for each award, brief information on each of the following: (1) a comparison of actual accomplishments with the goals and objectives established for the period, (2) reasons why established goals were not met, if appropriate, and (3) other pertinent information including, when appropriate, analysis and explanation of cost overruns or high unit costs. Performance reporting requirements are contained in the A-102 Common Rule (section .40(b), OMB Circular A-110 (section .51)), and the laws, regulations, and the provisions of contract or grant agreements pertaining to the program.

*Special Reporting*—Non-federal entities may be required to submit other reporting which may be used by the federal agency for such purposes as allocating program funding. Reporting requirements are contained in the laws, regulations, and the provisions of contract or grant agreements pertaining to the program.

*Audit Objective*—Determine whether required reports for federal awards include all activity of the reporting period, are supported by applicable accounting or performance records, and are fairly presented in accordance with program requirements.

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*Audit Procedures*

**Note:** Compliance testing of performance and special reporting are only required for data that are quantifiable and meet the following criteria: (1) have a direct and material effect on the program, and (2) are capable of evaluation against objective criteria stated in the laws, regulations, contract or grant agreements pertaining to the program.

**Note:** For recipients using PMS to draw federal funds, the auditor should consider the audit procedures as they pertain to the PMS 272, PMS 272-A, PMS 272-B, and PMS 272-E, regardless of the source of the data included in the PMS reports. Although certain data is supplied by the federal awarding agency and certain amounts are provided by DPM, the auditor should ensure that such amounts agree with the recipient's records and are otherwise accurate.

1. Review applicable laws, regulations, and provisions of contract or grant agreements pertaining to the program for reporting requirements. Determine the types and frequency of required reports. Obtain and review federal awarding agency or pass-through entity instructions for completing the reports.
  - a. For financial reports, determine the accounting basis used in reporting the data (such as, cash or accrual).
  - b. For performance and special reports, determine the criteria and methodology used in compiling and reporting the data.
2. Perform appropriate analytical procedures and determine the reason for any unexpected differences. Examples of analytical procedures include:
  - a. Comparing current period reports to prior period reports.
  - b. Comparing anticipated results to the data included in the reports.
  - c. Comparing information obtained during the audit of the financial statements to the reports.
3. Select a sample of each of the following report types.
  - a. Financial reports:
    - (1) Determine whether the financial reports were prepared in accordance with the required accounting basis.
    - (2) Trace the amounts reported to accounting records that support the audited financial statements and the schedule of expenditures of federal awards and verify agreement or perform alternative procedures to verify the accuracy and completeness of the reports and that they agree with the accounting records.
    - (3) For any discrepancies noted in PMS-272 reports, review subsequent PMS-272 reports to determine whether the discrepancies were appropriately resolved with the Department of Health and Human Services' Division of Payment Management.

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____



	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Performance and special reports:			
(1) Trace the data to records that accumulate and summarize data.	_____	_____	_____
(2) Perform tests of the underlying data to verify that the data were accumulated and summarized in accordance with the required or stated criteria and methodology, including the accuracy and completeness of the reports.	_____	_____	_____
c. When intervening computations or calculations are required between the records and the reports, trace reported data elements to supporting worksheets or other documentation that link reports to the data.	_____	_____	_____
d. Test the mathematical accuracy of the reports and supporting worksheets.	_____	_____	_____
4. Test the selected reports for completeness.			
a. For financial reports, review accounting records and determine whether all applicable accounts were included in the sampled reports (such as program income, expenditure credits, loans, interest earned on federal funds, and reserve funds).	_____	_____	_____
b. For performance and special reports, review the supporting records and determine whether all applicable data elements were included in the sampled reports.	_____	_____	_____
5. Obtain written representation from management that the reports provided to the auditor are true copies of the reports submitted or electronically transmitted to the federal awarding agency, the Department of Health and Human Services' Division of Payment Management, or pass-through entity.	_____	_____	_____

## M. Subrecipient Monitoring

### *Compliance Requirements*

- A pass-through entity is responsible for:
  - Identifying to the subrecipient the federal award information (such as CFDA title and number, award name, name of federal agency) and applicable compliance requirements.
  - Monitoring the subrecipient's activities to provide reasonable assurance that the subrecipient administers federal awards in compliance with federal requirements.
  - Ensuring required audits are performed and requiring the subrecipient to take prompt corrective action on any audit findings.
  - Evaluating the impact of subrecipient activities on the pass-through entity's ability to comply with applicable federal regulations.

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- Factors such as the size of awards, percentage of the total program's funds awarded to subrecipients, and the complexity of the compliance requirements may influence the extent of monitoring procedures. Monitoring activities may take various forms, such as reviewing reports submitted by the subrecipient, performing site visits to the subrecipient to review financial and programmatic records and observe operations, arranging for agreed-upon procedures engagements for certain aspects of subrecipient activities, reviewing the subrecipient's single audit or program-specific audit results and evaluating audit findings, and the subrecipient's corrective action plan.
- The requirements for subrecipient monitoring are contained in the A-102 Common Rule, OMB Circular A-110 (section .50(a)), federal awarding agency program regulations, and the terms and conditions of the award.

*Audit Objectives—Determine whether the pass-through entity:*

- Identified federal award information and compliance requirements to the subrecipient, and approved only allowable activities in the award documents.
- Monitored subrecipient activities to provide reasonable assurance that the subrecipient administers federal awards in compliance with federal requirements.
- Ensured required audits are performed and required appropriate corrective action on monitoring and audit findings.
- Evaluated the impact of subrecipient activities on its own activities.

*Audit Procedures*

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**Note:** The auditor may consider coordinating the tests related to subrecipients performed as part of Cash Management (tests of cash reports submitted by subrecipients), Eligibility (tests that subawards were made only to eligible subrecipients), and Procurement (tests of suspension and debarment certifications) with the testing of Subrecipient Monitoring.

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1. Discuss subrecipient monitoring with the pass-through entity's staff to gain an understanding of the scope of monitoring activities, including the number, size, and complexity of awards to subrecipients.
2. Test award documents and approved agreements to determine whether the pass-through entity made subrecipients aware of the award information and requirements imposed by laws, regulations and provisions of contract or grant agreements, and to verify that the activities approved in the award documents were allowable. This testing should include procedures to verify that the pass-through entity required subrecipients expending \$300,000 or more in federal awards during the subrecipient's fiscal year to have audits made in accordance with OMB Circular A-133.

_____	_____	_____
_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
3. Review the pass-through entity's documentation of subrecipient monitoring to determine whether the pass-through entity monitored that subrecipients used federal funds for authorized purposes and takes actions in response to monitoring findings. This review should include procedures to verify that the pass-through entity monitored the activities of subrecipients not subject to OMB Circular A-133, using techniques such as those discussed in the compliance requirements above.	_____	_____	_____
4. Verify that the pass-through entity receives audit reports from subrecipients required to have an audit in accordance with OMB Circular A-133, issues timely management decisions on audit and monitoring findings, and requires subrecipients to take timely corrective action on deficiencies identified in audits and subrecipient monitoring.	_____	_____	_____
5. Verify that the effects of subrecipient noncompliance are properly reflected in the pass-through entity's records.	_____	_____	_____

#### N. Special Tests and Provisions

**Compliance Requirements**—The specific requirements for Special Tests and Provisions are unique to each federal program and are found in the laws, regulations, and provisions of contract or grant agreements pertaining to the program. See Parts 4 and 5 of the *Compliance Supplement* for the compliance requirements, audit objectives, and suggested audit procedures for the programs listed therein. For programs not listed in the *Compliance Supplement*, the auditor should review the program's contract and grant agreements and referenced laws and regulations to identify the compliance requirements and develop the audit objectives and audit procedures for Special Tests and Provisions that could have a direct and material effect on a major program. The auditor also should inquire of the entity to help identify and understand any Special Tests and Provisions.

In addition, both for programs included and for those not included in the *Compliance Supplement*, the auditor should identify any additional compliance requirements that are not based in law or regulation (such as were agreed to as part of audit resolution of prior audit findings) that could be material to a major program. Reasonable procedures to identify such compliance requirements would be inquiry of the entity's management and review of the contract and grant agreements pertaining to the program. Any such requirements that may have a direct and material effect on a major program should be included in the audit.

**.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 amounts of tax-exempt 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.
  - Decreasing intergovernmental revenues.
- Expenditure-based indicators:
  - Increasing excesses of expenditures over revenues.
  - Increasing incidence of actual expenditures in excess of budgets.
- Cash management indicators:
  - Decreasing amounts of investments.
  - Increasing amounts of unpaid current obligations.
  - Decreasing income from 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.
  - Increases in amounts of long-term operating liabilities, such as compensated absences and net pension obligations.

**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.
  - Difficulty obtaining access to top management.
- 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 (such as economy and industry):
  - Large industrial plant closing or moving from community.
  - Environmental legislation or pressures.
  - Increasing unfunded mandates.
  - Significant changes in grant regulations.

**.180 XVIII. Appendix B—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.
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## AAM Section 12,210

### *Suggested Supplemental Reference Materials for Use With Illustrative Audit Programs for State and Local Governmental Units*

.01 Starting at AAM section 8070.109, the AICPA Audit Risk Alert, *State and Local Governmental Developments—1998*, includes references for governmental accounting and auditing guidance, including web site addresses and order department telephone numbers. At AAM section 8070.137, that Audit Risk Alert includes an appendix with references to useful web sites. Additional or updated information since the Audit Risk Alert was prepared is shown below.

#### **American Institute of Certified Public Accountants (AICPA)**

*Professional Standards*, which includes Statements on Auditing Standards, Interpretations of Auditing Standards, the Code of Professional Conduct, Statements on Quality Control Standards, and other professional standards.

Audit and Accounting Guide—*Audit Sampling*

Audit Guide—*Consideration of Internal Control in a Financial Statement Audit*

Audit and Accounting Guide—*Health Care Organizations*

Audit and Accounting Guide—*Colleges and Universities*

Audit and Accounting Guide—*Voluntary Health and Welfare Organizations*

Statement of Position 78-10—*Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

Audit and Accounting Guide—*Audits of Employee Benefit Plans*

Ethics Interpretation 101-10—“The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements” (reissued in 1996) (included in *Professional Standards*)

Ethics Interpretation 501-3—“Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits” (included in *Professional Standards*)

Statement of Auditing Standards No. 74—*Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (included in *Professional Standards*)

Statements on Quality Control Standards—*System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (included in *Professional Standards*)

*Checklists and Illustrative Financial Statements for State and Local Governmental Units* (September 1998 edition, product number 008707)

*The Year 2000 Issue: Current Accounting and Auditing Guidance* (Revised October 19, 1998)

**Governmental Accounting Standards Board**

*Publications order department: (800) 748-0659*

GASB Technical Bulletin No. 98-1, *Disclosures about Year 2000 Issues*

**Government Finance Officers Association**

*GAAFR Update Supplement—1998*

*The GAAFR Review Practice Guide—1997*

**Office of Management and Budget**

Circular A-110: *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations* (November 19, 1993, as further amended August 29, 1997)

Circular A-133 Compliance Supplement (Revised May 1998)

Data Collection Form (Form SF-SAC)

**General Accounting Office**

*Assessing the Reliability of Computer-Processed Data* (April 1991)

**Securities and Exchange Commission**

SEC Rule 15c2-12, relating to primary offerings of municipal securities (17 Code of Federal Regulations §240.15c2-12)<sup>1</sup>

SEC Interpretive Release No. 34-34961, *Municipal Securities Disclosures*

SEC Interpretive Release Nos. 33-7558 and 34-40277, *Disclosure of Year 2000 Issues and Consequences by Public Companies, Investment Advisers, Investment Companies, and Municipal Securities Issuers.*

**Other**

Single Audit Act Amendments of 1996, Public Law 104-156 (Appendix A of AICPA Statement of Position 98-3, *Audits of State, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*)

Applicable State Laws and Administrative Rules and Regulations

Local Government Charter

Local Laws, Rules, and Regulations

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<sup>1</sup> The Code of Federal Regulations, the *Federal Register*, and other documents relating to federal laws and regulations can be searched on the Internet at the National Archives and Records Administration Web site—<http://www.gpo.gov/nara/index.html>.



# AAM Section 12,300

## *Partner's Engagement Review Program Supplement for Governmental Units*

To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
<b>I. General Audit Procedures</b>			
<b>A. .010 General</b>			
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?	_____	_____	_____
b. Definition of the reporting entity indicating the related organizations, functions, and activities that are either included or excluded from the financial statements?	_____	_____	_____
c. Factors affecting the continued functioning of the government, such as legal limitations on revenue, expenditures, or debt service?	_____	_____	_____
2. If applicable, were adequate tests of internal controls made?	_____	_____	_____
3. Based on the assessed level of control risk, do the substantive tests (review, analysis, and detailed testwork) of account balances and transaction classes appear adequate?	_____	_____	_____
4. Did the audit appropriately consider newly issued or newly effective accounting and auditing standards?	_____	_____	_____
5. Does it appear that appropriate consideration was given to the entity's ability to continue as a going concern for a reasonable period of time?	_____	_____	_____
<b>II. Working Paper Areas</b>			
<b>A. .020 Budgetary Compliance and Reporting</b>			
1. Were appropriate procedures performed on the entity's budgetary compliance and reporting?	_____	_____	_____
<b>B. .030 Cash</b>			
1. Do the working papers indicate that the following were considered:			
a. Verification of collateral required of depository institutions for public funds?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
b. Compliance with the laws and regulations governing the deposit of public funds?	_____	_____	_____
c. Determination that all cash accounts have been identified and appropriately recorded?	_____	_____	_____
d. Determination that income from pooled cash accounts were properly allocated to the individual funds?	_____	_____	_____
<b>C. .040 Investments and Investment Income</b>			
1. Were investments reviewed to determine whether they are of the types authorized by law or comply with the applicable statutes and investment policy?	_____	_____	_____
2. Was the ownership of, custody arrangements for, and fair value of investments verified with third parties, as appropriate?	_____	_____	_____
3. Was investment income examined for proper allocation to the individual funds?	_____	_____	_____
<b>D. .050 Receivables, Including Interfund Receivables</b>			
1. Was a summary classifying receivables (such as notes and accounts receivable, taxes receivable, and interfund receivables) prepared or obtained?	_____	_____	_____
2. Were procedures performed to provide evidence that receivables have been recorded in the correct period?	_____	_____	_____
3. Were procedures performed to assess the reasonableness of allowances for doubtful accounts and the collectibility of receivables, including interfund receivables?	_____	_____	_____
4. Was receivable work coordinated with tests of revenues, including cutoff tests?	_____	_____	_____
<b>E. .060 Inventories and Prepaid Items</b>			
1. Do the working papers indicate that appropriate procedures were performed to test the entity's accounting and financial reporting for inventories and prepaid items?	_____	_____	_____
<b>F. .070 Fixed Assets</b>			
1. Was a review made to determine whether fixed assets are classified in the proper fund or fund group accounts and properly stated as to amount, including accumulated depreciation (if applicable)?	_____	_____	_____
<b>G. .080 Liabilities, Including Interfund Liabilities</b>			
1. Did procedures consider whether liabilities associated with the governmental funds are properly reported in the fund as current liabilities or included in the general long-term debt account group?	_____	_____	_____
2. Was consideration given to liabilities that might require accrual (such as payroll and fringe benefits) and to whether accrued expenses are reasonably stated?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
3. Were procedures performed to determine whether agency fund liabilities are appropriately reported?	_____	_____	_____
4. Was an examination made to determine whether:			
a. New debt issues are properly issued as required by the state constitution and state/local statutes and are recorded in the correct fund and/or account group?	_____	_____	_____
b. Debt restrictions, guarantees, and other debt commitments are properly disclosed?	_____	_____	_____
c. Conduit debt obligations and debt defeasances are recorded and disclosed in accordance with generally accepted accounting principles?	_____	_____	_____
5. Do the tests of interfund borrowings appear adequate with respect to:			
a. Legal restrictions, if any, on such borrowings?	_____	_____	_____
b. Authorization?	_____	_____	_____
c. Classification?	_____	_____	_____
<b>H. .090 Deferred Revenue</b>			
1. Do the working papers reflect consideration of whether the basis of deferring revenue is reasonable and consistent with restrictions imposed by the resource provider (including matching requirements) or by generally accepted accounting principles?	_____	_____	_____
<b>I. .100 Commitments and Contingencies</b>			
1. Do the working papers include indication of the following:			
a. Inspection of minutes of meetings of the governing board and key committees thereof, provisions of the entity's charter, and applicable statutes and changes therein?	_____	_____	_____
b. Inspection of executory contracts, such as with construction contractors and for year 2000 remediation?	_____	_____	_____
2. Have all material contingencies been properly considered, documented, and reported?	_____	_____	_____
<b>J. .110 Fund Equity</b>			
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?	_____	_____	_____
<b>K. .120 Revenues and Expenditures/Expenses, Including Interfund Transactions</b>			
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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
2. Was adequate consideration given to the entity's revenue and expenditure recognition policies?	_____	_____	_____
3. Do the working papers indicate that revenues and expenditures/expenses have been recognized in accordance with generally accepted accounting principles?	_____	_____	_____
4. Has it been determined that encumbrances are properly identified, supported, and recorded?	_____	_____	_____
5. Were appropriate tests of payroll performed, including account distribution?	_____	_____	_____
6. Do tests of pension expenditures/expenses and liabilities appear adequate?	_____	_____	_____
7. Was the entity's accounting and financial reporting of risk financing and related insurance activities appropriately considered?	_____	_____	_____
8. Have leases been examined to determine whether capital, sales, and direct financing leases have been properly accounted for?	_____	_____	_____
9. If a third party reimburses the entity 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?	_____	_____	_____
10. Do the working papers indicate that interfund transactions were properly approved and recorded?	_____	_____	_____

### III. Compliance With Single Audit Requirements

#### A. .130 Single Audit Requirements

1. Did we discuss and agree on the scope of the engagement with the entity?	_____	_____	_____
2. Did we, by reviewing contract files and receipts and disbursements, obtain reasonable assurance that the entity appropriately identified all federal awards and included those awards within the audit scope?	_____	_____	_____
3. Does the schedule of expenditures of federal awards present all required elements?	_____	_____	_____
4. Was appropriate consideration given to the single audit guidance issued by the Office of Management and Budget, including Circular A-133, <i>Audits of States, Local Governments, and Non-Profit Organizations</i> , and the <i>Compliance Supplement</i> ?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
5. Did we appropriately identify major programs?	_____	_____	_____
6. For each compliance requirement that could have a direct and material effect on each major program, did we plan tests of controls to achieve a low-assessed level of control risk, perform testing as planned, and document that work (except as indicated at step 7 below)?	_____	_____	_____
7. For those compliance requirements for which a low assessed level of control risk could not be achieved, did we document that conclusion in the working papers and, if appropriate, report a reportable condition or material weakness audit finding?	_____	_____	_____
8. Were all reportable conditions in internal control disclosed in the auditor's reports?	_____	_____	_____
9. In determining whether the entity has complied with applicable laws, regulations, and provisions of contracts and grant agreements that may have a material effect on each major federal program, did we:			
a. Consult appropriate sources, such as the <i>Compliance Supplement</i> , statutes, regulations, and agreements covering individual programs to identify the compliance requirements that apply to each major program and to determine which requirements to test?	_____	_____	_____
b. Perform tests to determine whether the entity complied with each of the fourteen types of compliance requirements, if material to the particular major program?	_____	_____	_____
c. Select representative numbers and types of test items for each compliance requirement for each major program?	_____	_____	_____
d. Report audit findings in accordance with criteria of OMB Circular A-133?	_____	_____	_____
e. Consider whether tests of compliance with the programs' requirements appear adequate to support the report on compliance?	_____	_____	_____
10. If warranted, did we communicate with the cognizant agency to avoid or minimize any disagreements or problems?	_____	_____	_____
11. Did the financial statement audit comply with the additional requirements of <i>Government Auditing Standards</i> ?	_____	_____	_____
12. Did we submit the report(s) to the organization audited and to those requiring or arranging for the audit within the required time?	_____	_____	_____

The audit engagement has been completed in accordance with professional standards and firm policy.

Partner \_\_\_\_\_ Date \_\_\_\_\_

[The next page is 12,401.]



## AAM Section 12,400

# *Auditors' Reports on Basic or General-Purpose Financial Statements for State and Local Governmental Units*

### .01 Unqualified Opinion on General-Purpose Financial Statements <sup>1</sup>

#### Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example'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.<sup>2</sup> 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>3</sup>

[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, 1998.]

<sup>1</sup> 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 the Audit and Accounting Guide *Audits of State and Local Governmental Units*, example A.4, "Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit."

<sup>2</sup> 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 the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States." The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

<sup>3</sup> 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 our report dated [date of report] on our consideration of the City of the Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

**.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<sup>1</sup> financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example'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.<sup>2</sup> 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>3</sup>

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 stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.<sup>4</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.2.]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> See AAM section 12,400.01, footnote 3.

<sup>4</sup> When reporting on supplementary data, the auditor should consider the effect of any modifications in the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09-.11, .13, and .14).



**.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<sup>1</sup> financial statements and the combining and individual fund and account group financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>2</sup> 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 the 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.<sup>3</sup>

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 stated, in all material respects, in relation to the financial statements of each of the respective individual funds and account groups taken as a whole.<sup>4</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.3.]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> See AAM section 12,400.01, footnote 3.

<sup>4</sup> 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 the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>1</sup> 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 the 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>2</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.4.]

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<sup>1</sup> See AAM section 12,400.01, footnote 2.

<sup>2</sup> See AAM section 12,400.01, footnote 3.

**.05 Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying general-purpose<sup>1</sup> financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example'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.<sup>2</sup> 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 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,<sup>3</sup> the assets and revenues of the *[identify fund type(s)—for example, special revenue fund type—or component unit column(s)]* 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 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>4</sup>

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.5.]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> If the amounts applicable to the omitted component unit have not been audited, insert the phrase *based on unaudited information*.

<sup>4</sup> 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 Financial Reporting Entity**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying general-purpose financial statements<sup>1</sup> 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.<sup>2</sup> Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general-purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general-purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall general-purpose financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The general-purpose financial statements referred to above do not include financial data of the *[identify the component unit(s) omitted]*, which should be included in order to conform with generally accepted accounting principles.

Because of the departure from generally accepted accounting principles identified above, as of June 30, 19X1, the assets and revenues of the *[identify fund type(s), e.g., special revenue fund type—or component unit column(s)]* would have increased by \$XXX,XXX and \$XXX,XXX, respectively, there would have been an excess of expenditures over revenues in that fund type *[or component unit(s)]* for the year of \$XXX,XXX, and the *[identify fund type(s) or component unit(s)]* fund balance would have been a deficit of \$XXX,XXX.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the general-purpose financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of City of Example, Any State as of June 30, 19X1, or the results of its operations or cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended.

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.5, footnote 14.]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

## .07 Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group<sup>1</sup>

### Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose<sup>2</sup> financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example'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.<sup>3</sup> 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 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<sup>4</sup> 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>5</sup>

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.6.]

<sup>1</sup> 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.

<sup>2</sup> See AAM section 12,400.01, footnote 1.

<sup>3</sup> See AAM section 12,400.01, footnote 2.

<sup>4</sup> If the amounts applicable to the omitted fund type or account group have not been audited, insert the phrase *based on unaudited information*.

<sup>5</sup> See AAM section 12,400.01, footnote 3.

**.08 Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type<sup>1</sup>**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying general-purpose<sup>2</sup> financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example'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.<sup>3</sup> 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 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<sup>4</sup> 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>5</sup>

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.7.]

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<sup>1</sup> See AAM section 12,400.07, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 1.

<sup>3</sup> See AAM section 12,400.01, footnote 2.

<sup>4</sup> If the amounts applicable to the omitted fund have not been audited, insert the phrase *based on unaudited information*.

<sup>5</sup> See AAM section 12,400.01, footnote 3.

**.09 Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying financial statements of the general fund of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>1</sup> 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.<sup>2</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.8.]

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<sup>1</sup> See AAM section 12,400.01, footnote 2.

<sup>2</sup> 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 the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>1</sup> 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 the 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 the cash flows for the year then ended in conformity with generally accepted accounting principles.<sup>2</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.9.]

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<sup>1</sup> See AAM section 12,400.01, footnote 2.

<sup>2</sup> See AAM section 12,400.01, footnote 3.



**.11 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<sup>1</sup> financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's 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.<sup>2</sup> 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.

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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>3</sup>

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.11.]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> See AAM section 12,400.01, footnote 3.

**.12 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<sup>1</sup> financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's 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 *[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 thereon has been furnished to us, and our opinion, insofar as it relates to the amounts included for *[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.<sup>2</sup> 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>3</sup>

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.12(A).]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> See AAM section 12,400.01, footnote 3.

**.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**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying general-purpose<sup>1</sup> financial statements and the combining and individual fund and account group financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express 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 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.<sup>2</sup> 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 the 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 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 ended in conformity with generally accepted accounting principles.<sup>3</sup>

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.12(B).]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> See AAM section 12,400.01, footnote 3.

**.14 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<sup>1</sup> financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's 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.<sup>2</sup> 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 the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.<sup>3</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.13.]

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<sup>1</sup> See AAM section 12,400.01, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> See AAM section 12,400.01, footnote 3.

**.15 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 the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards.<sup>1</sup> 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, 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.<sup>2,3</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.14.]

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<sup>1</sup> See AAM section 12,400.01, footnote 2.

<sup>2</sup> 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 5f and 8 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.05f and .08).

<sup>3</sup> See AAM section 12,400.01, footnote 3.

**.16 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 the Department of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These financial statements are the responsibility of the Department of Example'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.<sup>1</sup> 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 the 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 the cash flows for the year then ended in conformity with generally accepted accounting principles.<sup>2</sup>

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.15.]

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<sup>1</sup> See AAM section 12,400.01, footnote 2.

<sup>2</sup> See AAM section 12,400.01, footnote 3.

## **.17 Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards<sup>1</sup>**

### **Independent Auditor's Report**

Addressee:

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example'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 the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>2</sup> issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the 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 the City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.<sup>3</sup>

The accompanying schedule of expenditures of federal awards<sup>4</sup> is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the general-purpose financial statements. 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 stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.<sup>5</sup>

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<sup>1</sup> Auditors may also refer to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* for additional guidance on reporting on the general-purpose financial statements of a government.

<sup>2</sup> The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

<sup>3</sup> The following paragraph should be deleted if the schedule of expenditures of federal awards is not presented with the general-purpose financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. See AAM section 12,400.20, footnote 4 and .21, footnote 5 for additional guidance.

<sup>4</sup> If the auditor is reporting on additional supplementary information (for example, combining and individual fund and account group financial statements and schedules), this paragraph should be modified to describe the additional supplementary information. The example reports in appendix A of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), provide useful guidance.

<sup>5</sup> When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09-.11, .13, and .14).

[Signature]

[Date]

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 1 (AUD section 11,320).]



**.18 Report on Compliance and on Internal Control Over Financial Reporting<sup>1</sup> Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])<sup>2</sup>**

**Independent Auditor's Report**

Addressee:

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>3</sup> We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>4</sup> issued by the Comptroller General of the United States.

**Compliance**

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.<sup>5,6</sup>

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered Example Entity's internal control over financial reporting 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 over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.<sup>7</sup>

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<sup>1</sup> See paragraph 4.12 of the AICPA *Technical Practice Aids* (AUD section 11,320-4.12) for a description of internal control over financial reporting.

<sup>2</sup> The auditor should use the portions of AAM sections 12,400.18 and .19 that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of AAM section 12,400.19. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of AAM section 12,400.19.

<sup>3</sup> Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

<sup>4</sup> See AAM section 12,400.01, footnote 2.

<sup>5</sup> See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

<sup>6</sup> If the auditor has issued a separate letter to management to communicate matters 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: "However, we noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with paragraph 5.20 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

<sup>7</sup> If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "However, we noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>8,9</sup>

[*Signature*]

[*Date*]

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 2, as amended by SAS No. 87 (AUD section 11,320).]

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<sup>8</sup> If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and [*specify legislative or regulatory body*], and is not intended to be and should not be used by anyone other than these specified parties."

<sup>9</sup> The wording in this paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report*, which is effective for reports issued after December 31, 1998, with earlier application permitted.

**.19 Report on Compliance and on Internal Control Over Financial Reporting<sup>1</sup> Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (Reportable Instances of Noncompliance and Reportable Conditions Identified)<sup>2</sup>**

**Independent Auditor's Report**

**Addressee:**

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.<sup>3</sup> We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>4</sup> issued by the Comptroller General of the United States.

**Compliance**

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*<sup>5</sup> and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-2 and 97-5].<sup>6</sup>

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered Example Entity's internal control over financial reporting 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 over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Example Entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-1, 97-4, and 97-8].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements 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 over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions

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<sup>1</sup> See AAM section 12,400.18, footnote 1.

<sup>2</sup> See AAM section 12,400.18, footnote 2.

<sup>3</sup> See AAM section 12,400.18, footnote 3.

<sup>4</sup> See AAM section 12,400.01, footnote 2.

<sup>5</sup> See AAM section 12,400.18, footnote 5.

<sup>6</sup> If the auditor has issued a separate letter to management to communicate matters 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 also noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with chapter 5, paragraph 5.20 of *Government Auditing Standards*, which indicates that communications to "top" management should be referred to.

that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.<sup>7,8</sup>

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>9,10</sup>

[Signature]

[Date]

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 2A (AUD section 11,320).]

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<sup>7</sup> If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be replaced with language such as the following: "However, of the reportable conditions described above, we consider items [*list the reference numbers of the related findings, for example, 97-1 and 97-8*] to be material weaknesses."

<sup>8</sup> If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "We also noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

<sup>9</sup> If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and [*specify legislative or regulatory body*], and is not intended to be and should not be used by anyone other than these specified parties." All references to the schedule of findings and questioned costs should also be removed, and instead, a description of the findings should be included in the report."

<sup>10</sup> See AAM section 12,400.18, footnote 9.

**.20 Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])<sup>1</sup>**

**Independent Auditor's Report**

Addressee:

**Compliance**

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>2</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-3 and 97-6].<sup>3</sup>

**Internal Control Over Compliance**

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design

<sup>1</sup> The auditor should use the portions of AAM section 12,400.20 and AAM section 12,400.21 that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of AAM section 12,400.21. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of AAM section 12,400.21.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance and its operation that we consider to be material weaknesses.<sup>4</sup>

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>5</sup>

[Signature]

[Date]

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 3, as amended by SAS No. 87 (AUD section 11,320).]

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<sup>4</sup> As noted in notes 3 and 9, there may be instances in which it would be appropriate to report on the schedule of expenditures of federal awards in this report (that is, a separate single audit package is issued). In such a circumstance, a new section should be added immediately following this paragraph as follows:

Schedule of Expenditures of Federal Awards

We have audited the [*general-purpose or basic*] financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. Our audit was performed for the purpose of forming an opinion on the [*general-purpose or basic*] financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the [*general-purpose or basic*] financial statements. Such information has been subjected to the auditing procedures applied in the audit of the [*general-purpose or basic*] financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the [*general-purpose or basic*] financial statements taken as a whole.

Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Auditors should also refer to notes 5 and 11 for additional guidance.

<sup>5</sup> See AAM section 12,400.18, footnote 9.

**.21 Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Qualified Opinion on Compliance and Reportable Conditions Identified)<sup>1</sup>**

**Independent Auditor's Report**

Addressee:

**Compliance**

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>2</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in item [*list the reference numbers of the related findings, for example, 97-10*] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [*identify the type(s) of compliance requirement*] that are applicable to its [*identify the major federal program*]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1.<sup>3</sup>

**Internal Control Over Compliance**

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

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<sup>1</sup> See AAM section 12,400.20, footnote 1.

<sup>2</sup> See AAM section 12,400.01, footnote 2.

<sup>3</sup> When other instances of noncompliance are identified in the schedule of findings and questioned costs as required by Circular A-133, the following sentence should be added: "The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-3 and 97-6*]."

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.<sup>4,5</sup>

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>6</sup>

*[Signature]*

*[Date]*

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 3A, as amended by SAS No. 87 (AUD section 11,320).]

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<sup>4</sup> See AAM section 12,400.19, footnote 7.

<sup>5</sup> See AAM section 12,400.20, footnote 4.

<sup>6</sup> See AAM section 12,400.18, footnote 9.



**.22 Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified)**

**Independent Auditor's Report**

Addressee:

**Compliance**

We have audited the compliance of Example Entity with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>1</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the compliance of Example Entity with [identify the major federal program] regarding [identify the type(s) of compliance requirement], nor were we able to satisfy ourselves as to Example Entity's compliance with those requirements by other auditing procedures.

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 Example Entity's compliance with the requirements of [identify the major federal program] regarding [identify the type(s) of compliance requirement], Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.<sup>2</sup>

**Internal Control Over Compliance**

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could

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<sup>1</sup> See AAM section 12400.01, footnote 2.

<sup>2</sup> See AAM section 12,400.21, footnote 3.

adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as *items* [list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.<sup>3,4</sup>

This report is intended solely for the information and use of the audit committee, management, [specify legislative or regulatory body], and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>5</sup>

[Signature]

[Date]

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 4, as amended by SAS No. 87 (AUD section 11,320).]

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<sup>3</sup> See AAM section 12,400.19, footnote 7.

<sup>4</sup> See AAM section 12,400.20, footnote 4.

<sup>5</sup> See AAM section 12,400.18, footnote 9.

**.23 Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses Identified)**

**Independent Auditor's Report**

Addressee:

**Compliance**

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>1</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in items [*list the reference numbers of the related findings, for example, 97-10, 97-11, and 97-12*] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [*identify the types of compliance requirements*] that are applicable to its [*identify the major federal program*]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, Example Entity did not comply in all material respects, with the requirements referred to above that are applicable to [*identify the major federal program*]. Also, in our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.<sup>2</sup>

**Internal Control Over Compliance**

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to signifi-

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<sup>1</sup> See AAM section 12,400.01, footnote 2.

<sup>2</sup> See AAM section 12,400.21, footnote 3.

cant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items *[list the reference numbers of the related findings, for example 97-8 and 97-9]* to be material weaknesses.<sup>3</sup>

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.<sup>4</sup>

*[Signature]*

*[Date]*

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 5, as amended by SAS No. 87 (AUD section 11,320).]

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<sup>3</sup> See AAM section 12,400.20, footnote 4.

<sup>4</sup> See AAM section 12,400.18, footnote 9.

**.24 Unqualified Opinion on the Financial Statements of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133**

**Independent Auditor's Report**

Addressee:

We have audited the accompanying schedule of expenditures of federal awards for the [identify the federal program] of Example Entity for the year ended June 30, 19X1. This financial statement is the responsibility of Example Entity's management. Our responsibility is to express an opinion on the financial statement of the program based on our audit.<sup>1</sup>

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>2</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and the 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 schedule of expenditures of federal awards referred to above<sup>3</sup> presents fairly, in all material respects, the expenditures of federal awards under the [identify the federal program] in conformity with generally accepted accounting principles.<sup>4,5</sup>

[Signature]

[Date]

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 6 (AUD section 11,320).]

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<sup>1</sup> In many cases, the financial statements of the program will consist only of the schedule of expenditures of federal awards (and notes to the schedule), which is the minimum financial statement presentation required by section 235 of Circular A-133. If the auditee issues financial statements that consist of more than the schedule, this paragraph should be modified to describe the financial statements. Also refer to paragraph 11.10 for a discussion of the possible necessity to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

<sup>2</sup> See footnote 2.

<sup>3</sup> If the auditee issues financial statements that consist of more than the schedule, this sentence should be modified to identify the results displayed in the financial presentation.

<sup>4</sup> The auditor should follow the guidance in SAS No. 62, *Special Reports* when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than GAAP.

<sup>5</sup> If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 11.10), an additional paragraph should be added as follows: "In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants."

**.25 Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133<sup>1</sup> (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])<sup>2</sup>**

**Independent Auditor's Report**

Addressee:

**Compliance**

We have audited the compliance of Example Entity with the types of compliance requirements described in the U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement that are applicable to [identify the federal program] for the year ended June 30, 19X1. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,<sup>3</sup> issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on [identify the federal program] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to its [identify the federal program] for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-1 and 97-2].<sup>4</sup>

**Internal Control Over Compliance**

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on its [identify the federal program] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

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<sup>1</sup> This is an example of a report on a program-specific audit under Circular A-133 when no federal audit guide applicable to the program being audited is available. When a federal audit guide applicable to the program is available, Circular A-133 requires that the auditor follow the reporting requirements of that federal audit guide (see paragraph 11.4 for a discussion of the auditor's responsibility when a program-specific audit guide is not current).

<sup>2</sup> If issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report to be consistent with the wording used in AAM section 12,400.21 or AAM section 12,400.25, accordingly. If reporting reportable conditions, including material weaknesses, the auditor should modify the internal control section of this report to be consistent with the wording used in AAM section 12,400.21.

<sup>3</sup> See AAM section 12,400.01, footnote 2.

<sup>4</sup> See AAM section 12,400.20, footnote 3.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program 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 over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and the federal awarding agency and pass-through entity and is not intended to be and should not be used by anyone other than these specified parties.<sup>5</sup>

[*Signature*]

[*Date*]

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 6A, as amended by SAS No. 87 (AUD section 11,320).]

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<sup>5</sup> See AAM section 12,400.18, footnote 9.

**.26 Illustrative Schedule of Findings and Questioned Costs**

**Example Entity**  
**Schedule of Findings and Questioned Costs**  
**For the Year Ended June 30, 19X1**

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**Section I—Summary of Auditor's Results**

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*Financial Statements*Type of auditor's report issued [*unqualified, qualified, adverse, or disclaimer*]:

Internal control over financial reporting:

- Material weakness(es) identified? \_\_\_\_\_ yes \_\_\_\_\_ no
- Reportable condition(s) identified that are not considered to be material weaknesses? \_\_\_\_\_ yes \_\_\_\_\_ none reported

Noncompliance material to financial statements noted?

\_\_\_\_\_ yes \_\_\_\_\_ no

*Federal Awards*

Internal control over major programs:

- Material weakness(es) identified? \_\_\_\_\_ yes \_\_\_\_\_ no
- Reportable condition(s) identified that are not considered to be material weakness(es)? \_\_\_\_\_ yes \_\_\_\_\_ none reported

Type of auditor's report issued on compliance for major programs [*unqualified, qualified, adverse, or disclaimer*]:<sup>1</sup>

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133?

\_\_\_\_\_ yes \_\_\_\_\_ no

Identification of major programs:<sup>2</sup>CFDA Number(s)<sup>3</sup>Name of Federal Program or Cluster<sup>4</sup>


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Dollar threshold used to distinguish between type A and type B programs:

\$ \_\_\_\_\_

Auditee qualified as low-risk auditee?

\_\_\_\_\_ yes \_\_\_\_\_ no

<sup>1</sup> If the audit report for one or more major programs is other than unqualified, indicate the type of report issued for each program. For example, if the audit report on major program compliance for an auditee having five major programs includes an unqualified opinion for three of the programs, a qualified opinion for one program, and a disclaimer of opinion for one program, the response to this question could be as follows: "Unqualified for all major programs except for [name of program], which was qualified and [name of program], which was a disclaimer."

<sup>2</sup> Major programs should generally be identified in the same order as reported on the schedule of expenditures of federal awards.

<sup>3</sup> When the CFDA number is not available, include other identifying number, if applicable.

<sup>4</sup> The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards. For clusters, auditors are only required to list the name of the cluster and not each individual program within the cluster.



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## Section II—Financial Statement Findings

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*[This section identifies the reportable conditions, material weaknesses, and instances of noncompliance related to the financial statements that are required to be reported in accordance with paragraphs 5.18 through 5.20 of Government Auditing Standards. Auditors should refer to those paragraphs, as well as the reports content section of chapter 7 of Government Auditing Standards, for additional guidance on preparing this section of the schedule.]*

*Identify each finding with a reference number.<sup>5</sup> If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that effects an entity as a whole, including its federal awards, would generally be reported in detail in this section. Section III would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:*

- Criteria or specific requirement
- Condition
- Questioned costs
- Context<sup>6</sup>
- Effect
- Cause
- Recommendation
- Management's response<sup>7</sup>

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## Section III—Federal Award Findings and Questioned Costs

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*[This section identifies the audit findings required to be reported by section 510(a) of Circular A-133 (for example, reportable conditions, material weaknesses, and instances of noncompliance, including questioned costs). Where practical, findings should be organized by federal agency or pass-through entity.]*

*Identify each finding with a reference number.<sup>8</sup> If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a finding of noncompliance with a federal program law that is also material to the financial statements would generally be reported in detail in this section. Section II would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:*

- Information on the federal program<sup>9</sup>
- Criteria or specific requirement (including statutory, regulatory, or other citation)

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<sup>5</sup> A suggested format for assigning reference numbers is to use the last two digits of the fiscal year being audited, followed by a numeric sequence of findings. For example, findings identified and reported in the audit of fiscal year 1997 would be assigned reference numbers of 97-1, 97-2, etc.

<sup>6</sup> Provide sufficient information for judging the prevalence and consequences of the finding, such as the relation to the universe of costs and/or the number of items examined and quantification of audit findings in dollars.

<sup>7</sup> See paragraphs 5.18 through 5.20 and 7.38 through 7.42 of *Government Auditing Standards* for additional guidance on reporting management's response.

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

<sup>9</sup> Provide the federal program (CFDA number and title) and agency, the federal award's number and year, and the name of the pass-through entity, if applicable. When this information is not available, the auditor should provide the best information available to describe the federal award.

- *Condition*<sup>10</sup>
- *Questioned costs*<sup>11</sup>
- *Context*<sup>12</sup>
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*<sup>13]</sup>

[Source: Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix E (AUD section 11,320).]

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<sup>10</sup> Include facts that support the deficiency identified in the audit finding.

<sup>11</sup> Identify questioned costs as required by sections 510(a)(3) and 510(a)(4) of Circular A-133.

<sup>12</sup> See footnote 6.

<sup>13</sup> To the extent practical, indicate when management does not agree with the finding, questioned cost, or both.

**.27 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.<sup>1</sup>

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: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.17.]

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<sup>1</sup> Describe any departure from the standard report.

**.28 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.<sup>1</sup>

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*]<sup>2</sup> 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.18.]

[*The next page is 12,431.*]

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<sup>1</sup> Describe any departure from the standard report.

<sup>2</sup> 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.

**.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.<sup>1</sup>

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.<sup>2</sup>

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.23(C).]

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<sup>1</sup> Describe any departure from the standard report.

<sup>2</sup> 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<sup>1</sup>**

**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.<sup>2</sup>

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.<sup>3</sup> 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.<sup>4</sup>

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.24.]

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<sup>1</sup> See AAM section 12,400.28, footnote 3, for modification when material noncompliance is detected.

<sup>2</sup> Describe any departure from the standard report.

<sup>3</sup> 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.

<sup>4</sup> If there are no instances of noncompliance, this sentence should be deleted.

**.31 Report on the Internal Control Structure Based on an Audit of General-Purpose Financial Statements Performed in Accordance With *Government Auditing Standards***

**Independent Auditor's Report**

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.<sup>1</sup>

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.<sup>2</sup>

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the general-purpose financial statements of City of Example, Any State, for the year ended June 30, 19XX, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the general-purpose financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the general-purpose financial statements.

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the general-purpose financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

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<sup>1</sup> Describe any departure from the standard report.

<sup>2</sup> 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.<sup>3</sup>

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.<sup>4</sup>

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.]

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<sup>3</sup> 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.*]

<sup>4</sup> If a separate letter has not been issued, this paragraph should be omitted.



**.32 Report on the Internal Control Structure Based on an Audit of General-Purpose or Basic Financial Statements Performed in Accordance With *Government Auditing Standards*—No Material Weaknesses When There Are No Reportable Conditions**

**Independent Auditor's Report**

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.<sup>1</sup>

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.<sup>2</sup> 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.

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<sup>1</sup> Describe any departure from the standard report.

<sup>2</sup> 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.<sup>3</sup>

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]

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**Note:** As of the date of this publication, the AICPA Federal Government Division was in the process of revising this report to conform it to the requirements of the 1994 revision of *Government Auditing Standards* (the Yellow Book). Auditors should ascertain the status of those revisions before issuing this report.

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.25(B).]

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<sup>3</sup> If a separate letter has not been issued, this paragraph should be omitted.

### .33 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs

#### Independent Auditor's Report

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.<sup>1</sup> 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,<sup>2</sup> 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*].<sup>3</sup>

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<sup>1</sup> Describe any departure from the standard report.

<sup>2</sup> If the financial statements are on a basis other than GAAP, the phrase "generally accepted accounting principles" should be modified.

<sup>3</sup> 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.<sup>4</sup>

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*

<sup>4</sup> If a cyclical approach is used, this paragraph should be modified, and a paragraph that clearly describes the coverage provided for nonmajor programs should be added after it as follows:

Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs on a cyclical basis. Our procedures during the current year covered X percent of the nonmajor programs administered by City of Example, Any State, as a whole. The nonmajor programs not covered during the current year have been or are expected to be subject to such procedures at least once during the X year cycle.

We performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations.

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.<sup>5</sup>

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.<sup>6</sup>

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).]*

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<sup>5</sup> 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.]*

<sup>6</sup> 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<sup>1</sup>**

**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 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.

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<sup>1</sup> See footnotes to AAM section 12,400.33.

We performed test of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the major federal financial assistance programs of City of Example, Any State, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

Our consideration of the internal control structure policies and procedures used in administering federal financial assistance would not necessarily disclose all matters in the internal control structure that might constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [specify legislative or regulatory body]. However, this report is a matter of public record and its distribution is not limited.

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.26(B).]

**.35 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Tests of Controls Are Performed for Certain Compliance Requirements<sup>1</sup>**

**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.

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<sup>1</sup> See footnotes to AAM section 12,400.33.



Except as discussed in the following paragraph, we performed tests of controls, as required by OMB Circular A-128, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of City of Example, Any State's major federal financial assistance programs, which are identified in the accompanying Schedule of Federal Financial Assistance. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

For *[identify relevant federal financial assistance programs]*, we performed no tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that could be relevant to preventing or detecting material noncompliance with *[identify relevant compliance requirements]*. We did not perform such tests because the results of procedures we performed to obtain an understanding of the design of internal control structure policies and procedures and whether they have been placed in operation indicated that *[describe the absence of relevant policies and procedures or the circumstances that cause the auditor to conclude that policies and procedures are unlikely to be effective]*. We consider this condition to be a reportable condition under standards established by the American Institute of Certified Public Accountants.

Reportable conditions involve matters coming to our attention concerning significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect City of Example, Any State's ability to administer federal financial assistance programs in accordance with applicable laws and regulations. In addition to the reportable conditions identified in the preceding paragraph, we noted other matters involving the internal control structure and its operation that we consider to be reportable conditions.

*[Include paragraphs to describe the reportable conditions noted.]*

A material weakness is a reportable condition in which in the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal financial assistance program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operations that we have reported to the management of City of Example, Any State, in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record, and its distribution is not limited.

*[Signature]*

*[Date]*

*[Source: AICPA Audit and Accounting Guide Audits of State and Local Governmental Units, Appendix A, Example A.26(C).]*

**.36 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—Total Assistance Expended Under Major Programs Is Less Than 50 Percent of Federal Financial Assistance**

**Independent Auditor's Report**

Addressee:

We have audited the general-purpose financial statements of City of Example, Any State, as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.<sup>1</sup> 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,<sup>2</sup> 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*].<sup>3</sup>

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<sup>1</sup> Describe any departure from the standard report.

<sup>2</sup> If the financial statements are on a basis other than GAAP, the phrase "generally accepted accounting principles" should be modified.

<sup>3</sup> Following are examples of different ways in which internal control structure policies and procedures used in administering federal financial assistance programs might be classified. The auditor should modify these examples or use other classifications as appropriate for the particular circumstances on which the auditor is reporting. However, there is no need to present detailed internal control structure policies and procedures, even though test work may be performed at that level.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risk.<sup>4</sup>

During the year ended June 30, 19XX, City of Example, Any State, expended X percent of its total federal financial assistance under major federal financial assistance programs and the following nonmajor federal

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*Activity Cycles*

- Treasury or financing
- Revenue/receipts
- Purchases/disbursements
- External financial reporting
- Payroll/personnel

*Financial Statement Captions*

- Cash and cash equivalents
- Receivables
- Inventory
- Property and equipment
- Payables and accrued liabilities
- Debt
- Fund balance

*Accounting Applications*

- Billings
- Receivables
- Cash receipts
- Purchasing and receiving
- Accounts disbursements
- Payroll
- Inventory control
- Property and equipment
- General ledger

*General Requirements*

- Political activity
- Davis-Bacon Act
- Civil rights
- Cash management
- Relocation assistance and real property management
- Federal financial reports
- Allowable costs/cost principles
- Drug-free workplace
- Administrative requirements

*Specific Requirements*

- Types of services
- Eligibility
- Matching, level of effort, or earmarking
- Reporting
- Cost allocation
- Special requirements, if any
- Monitoring subrecipients

*Claims for Advances and Reimbursements*

*Amounts Claimed or Used for Matching*

<sup>4</sup> 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.<sup>5</sup>

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.<sup>6</sup>

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of a public record, and its distribution is not limited.

*[Signature]*

*[Date]*

*[Source: AICPA Audit and Accounting Guide Audits of State and Local Governmental Units, Appendix A, Example A.26(D).]*

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<sup>5</sup> 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.]*

<sup>6</sup> If a separate letter has not been issued, this paragraph should be omitted.

**.37 Single Audit Report on the Internal Control Structure Used in Administering Federal Financial Assistance Programs—No Major Programs<sup>1</sup>**

**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-

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<sup>1</sup> 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.<sup>2</sup>

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.<sup>3</sup>

This report is intended for the information of the audit committee, management, and *[specify legislative or regulatory body]*. However, this report is a matter of public record, and its distribution is not limited.

*[Signature]*

*[Date]*

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.26(E).]

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<sup>2</sup> 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.]*

<sup>3</sup> If a separate letter has not been issued, this paragraph should be omitted.

**.38 Report on Separately Issued Summary Financial Information Prepared in Accordance With the Guidance Provided in Paragraph 18.23 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units***

**Independent Auditor's Report**

Addressee:

We have audited, in accordance with generally accepted auditing standards, the general-purpose financial statements of City of Example as of and for the year ended June 30, 19XX (not presented herein), and have issued our report thereon dated August 15, 19XX.<sup>1</sup>

As explained in Note X, the accompanying summary financial information of City of Example, as of and for the year ended June 30, 19XX, is not a presentation in conformity with generally accepted accounting principles. In our opinion, however, the accompanying summary financial information is fairly stated, in all material respects, in relation to the general-purpose financial statements from which it has been derived.

[Signature]

[Date]

[Source: AIPCA Audit and Accounting Guide *Audits of State and Local Governmental Units*, Appendix A, Example A.27.]

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<sup>1</sup> 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.<sup>1</sup>

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*<sup>2</sup> 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.]

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[The next page is 20,001.]

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<sup>1</sup> Describe any departure from the standard report.

<sup>2</sup> A different measurement focus and basis of accounting would include changing from a modified accrual basis of accounting to a cash basis, recording depreciation on general fixed assets through the operating statement of a governmental fund type, etc.



# AAM TOPICAL INDEX

References are to section and paragraph numbers.

[*Reserved.*]

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